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# In the Supreme Court of the United States

**October Term, 1981**

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent,*

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED,
*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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## QUESTION PRESENTED

Does the donor of appreciated property, given on condition that the donee agree to pay the resulting gift taxes, realize taxable income upon the donee's payment of the gift taxes?

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UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
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COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

---

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

COME NOW Petitioners Victor P. Diedrich and Frances T. Diedrich and United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, deceased, through their attorneys, and petition this Court for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit.

## OPINIONS BELOW

The opinion of the Court below is reported as *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). That opinion reversed decisions of the United States Tax Court reported as *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979) and *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980) which had been consolidated in the Court of Appeals for argument and disposition. For convenience, these cases will be referred to as *Diedrich* and *Grant*.

## JURISDICTION

The opinion of the United States Court of Appeals for the Eighth Circuit was filed March 4, 1981, and judgment was entered on that day. On May 13, 1981, and March 17, 1981, petitions for rehearing en banc were filed respectively by counsel for *Diedrich* and *Grant*. These petitions were denied by the Court of Appeals on March 27, 1981. Copies of the orders of the Court of Appeals denying the petitions for rehearing are included in the Appendix E at pages A25 and A26. Jurisdiction by writ of certiorari is vested in the United States Supreme Court by 28 U.S.C. § 1254 (1976).

## STATUTORY PROVISIONS INVOLVED

Section 61 of Title 26 U.S.C. provides:

> Except as otherwise provided in this sub-title, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rent;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuity;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect to a decedent; and

(15) Income from an interest in an estate or trust.

Section 102 of Title 26 U.S.C. provides in relevant part:

(a) Gross income does not include the value of property acquired by gift, bequest, devise or inheritance.

Section 1001 of Title 26 U.S.C. provides in relevant part:

(a) The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the

excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) The amount realized from the sale or the disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 2502 of Title 26 U.S.C. provides in relevant part:

(d) The tax imposed by 2501 shall be paid by the donor.

Section 7805 of Title 26 U.S.C. provides in relevant part:

(a) Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Section 6324 of Title 26 U.S.C. provides in relevant part:

(b) Except as otherwise provided in subsection (c), unless the gift tax imposed by chapter 12 is sooner paid in full or becomes unenforceable by reason of lapse of time, such tax shall be a lien upon all gifts made during the calendar year, for 10 years from the date the gifts are made. If the tax is not paid when due the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.

Section 6901 of Title 26 U.S.C. provides in relevant part:

(a) the amounts of the following liabilities shall, except as hereinafter in this Section provided, be assessed, paid and collected in the same manner and subject to the same provisions and limitations as in

the case of the taxes with respect to which the liabilities were incurred:

(1) Income, estate and gift taxes—

(a) The liability, at law or in equity, of a transferee of property—

* * *

(iii) of a donor in the case of a tax imposed by chapter 12 (relating to gift taxes),

in respect of the tax imposed by sub-title A or B.

Revenue Ruling 75-72 provides in relevant part:

> If at the time of the transfer, the gift is made subject to a condition that the gift tax be paid by the donee or out of the transferred property, the donor receives consideration for the transfer in the amount of gift tax to be paid by the donee. Under these circumstances, the value of the gift is measured by the fair-market value of the property or property right or interest passing from the donor, minus the amount of the gift tax to be paid by the donee.

## STATEMENT OF THE CASE

This case involves another round in the Commissioner of Internal Revenue's attempt to treat federal gift tax paid by the donee of a gift as income to the donor. The Commissioner proposed income tax deficiences against both taxpayers for failure to include as income in their federal income tax returns federal gift tax paid by the donees of gifts made by taxpayers. Separate petitions for redetermination of the deficiences were filed in the United States

Tax Court, which had jurisdiction under 26 U.S.C. § 6213 (1976). In separate opinions, the United States Tax Court held that the donors did not realize income as the result of the donees paying the federal gift tax. The Commissioner appealed both cases pursuant to 26 U.S.C. § 7482 (1976). The cases were consolidated for decision before the United States Court of Appeals for the Eighth Circuit.

The relevant facts are undisputed and there are no material distinctions between the two cases consolidated in this petition. Accordingly, the factual situation will be described by reference to the *Grant* case. In 1970, in reliance on existing law, Frances D. Grant gave 50,000 voting trust certificates, representing underlying common stock of BMA Corporation, to her son subject to his express agreement to pay the resulting gift taxes. In January, 1971, Mrs. Grant gave an additional 40,000 voting trust certificates to her son subject to the same condition. The gift taxes on both transfers were due in the spring of 1971 and these taxes, totalling $232,630, were paid by Mrs. Grant's son.

Mrs. Grant did not report any income in connection with the net gifts in either her 1970 or 1971 federal income tax returns. The Commissioner of Internal Revenue, however, determined that these gifts resulted in taxable income to Mrs. Grant computed as follows:

| | |
|---|---|
| Gift taxes paid | $232,630.09 |
| Less: Basis in securities transferred | 8,742.60 |
| Long-term capital gain | 223,887.49 |
| 50% deduction for capital gain | 111,943.74 |
| Increase in taxable income | $111,943.75 |

The Commissioner theorized that Mrs. Grant's gifts were, in part, sales of the property to her son and her gain was

measured by the difference between the gift taxes paid by Mrs. Grant's son and her basis in the voting trust certificates.

Mrs. Grant filed a petition for redetermination of the proposed deficiencies in the United States Tax Court. In a Memorandum Opinion filed February 27, 1980, Mrs. Grant's motion for judgment on the pleadings was sustained and the proposed deficiencies were set aside. The Tax Court's opinion in favor of the taxpayer in *Diedrich* was filed on February 13, 1980. The Commissioner's appeals from the Tax Court's decisions in *Grant* and *Diedrich* were consolidated for oral argument and disposition in the United States Court of Appeals for the Eighth Circuit. On March 4, 1981, the Court of Appeals reversed the Tax Court's decision in each case. The Court of Appeals held that the taxpayers in both *Grant* and *Diedrich* received a benefit upon payment of the gift taxes by the donees and that the benefits received resulted in taxable income measured by the difference between the gift taxes paid and the donors' adjusted bases in the property.

## REASONS FOR GRANTING THE PETITION

These cases involve the *income tax* consequence of a popular tax and estate planning technique commonly referred to as a "net gift." In a net gift transaction, the donee pays the gift taxes and with a "pure" net gift the donor does not personally realize any money or other property. The technique has been in use for many years and has been the subject of litigation relating to various aspects of the transaction since 1942. The gift tax consequences are established: for gift tax purposes, the value of the gift equals the value of the property transferred less the gift taxes paid. Rev. Rul. 75-72. The issue in these cases is

whether or not there is an *income tax* consequence to the donor of a pure net gift of appreciated property.

## I. Conflicts Between Courts of Appeals

The United States Tax Court first considered this question in *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd sub nom. Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969). In that case, the taxpayer made gifts of appreciated stock outright to several individuals and in trust for certain other individuals. All of the gifts were subject to an express condition that the donees pay the resulting gift taxes, which was done. The question before the Tax Court was identical to the question presented here, whether the payment by the donees of the federal gift tax resulting from the gifts resulted in income to the taxpayer. The Tax Court held that the donees' payment of the gift tax did *not* result in income to the taxpayer. In reaching that conclusion, the Tax Court reasoned that the condition imposed by a transferor that the transferee pay the gift tax resulting from the transfer does not alter the nature of the transfer as a gift. *Id.* at 362. Because gifts are not taxable as income to either the donor on the donee, 26 U.S.C. § 102 (1976), and because the Tax Court found that the transfer in question was a gift, the Tax Court held that the gifts did not result in a taxable gain to the taxpayer. *Turner v. Commissioner*, 49 T.C. at 364. The Tax Court's decision was affirmed by the Sixth Circuit. *Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969).

The holding in *Turner v. Commissioner*, was followed by the United States Courts of Appeals for the Fourth and Fifth Circuits in cases involving substantively identical facts. *Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner*, 469 F.2d 694 (5th Cir. 1972). In cases not involving net gifts the Courts of Ap-

peals for two additional circuits have suggested in dicta how they would decide net gift cases. In *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980), the Second Circuit suggests it would decide the net gift question in favor of the Commissioner. In *Evangelista v. Commissioner*, 71 T.C. 1057 (1979), *aff'd* 629 F.2d 1218 (7th Cir. 1980), the Seventh Circuit suggests it would decide the net gift question in favor of the taxpayer.

## II. Cases Pending in Courts of Appeals

The Tax Court has decided six net gift cases which are now on appeal to the Courts of Appeals. *Bradford v. Commissioner*, 70 T.C. 584 (1978) (Commissioner on appeal to Sixth Circuit); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978) (Commissioner on appeal to Sixth Circuit); *McNeice v. Commissioner*, 41 T.C.M. (CCH) 969 (Commissioner on appeal to Ninth Circuit); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979) (Commissioner on appeal to Ninth Circuit); *Estate of Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978) (Commissioner on appeal to Sixth Circuit); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978) (Commissioner on appeal to Sixth Circuit). All involve pure net gifts and were decided in favor of the taxpayers. Substantial asserted tax liabilities are at stake, to wit:

*Estate of Henry*—$686,000
*Benson*—$16,500
*Bradford*—$125,000
*Owen*—$502,000
*McNeice*—$148,000
*Estate of Weeden*—$23,000.

In addition, the United States District Court for the Northern District of Iowa followed the Eighth Circuit's *Diedrich* ruling in *Molinaro v. Estate of Warren,* Federal Tax Reporter ¶9362 (March 24, 1981). This case, which is a refund action, is currently on appeal to the Eighth Circuit, but that Court has stayed consideration of the appeal pending this Court's ruling on this Petition.

### III. Eighth Circuit's Ruling Below

The Commissioner has asserted basically two theories for imposing an income tax on net gifts. The first is that the net gift is a part gift, part sale transaction. In these cases, as well as in the other net gift cases it has considered, the Tax Court has found that the transfers were intended as gifts, not as sales. A gift does not give rise to income and the Commissioner's theory has been uniformly rejected. This theory of taxation has largely been abandoned by the Commissioner. Although this was the theory of the proposed deficiency in *Grant,* it was not urged by the Commissioner before the Eighth Circuit and it was not discussed by the Court.

The Commissioner asserted before the Eighth Circuit that the taxpayers in *Grant* and *Diedrich* recognized a real and substantial economic benefit. The Eighth Circuit agreed, finding that a taxable benefit had been realized when the gift tax liability was discharged. *Diedrich v. Commissioner,* 643 F.2d 499, 504.

The petitioners respectfully submit that the Eighth Circuit's decision is erroneous. It is based upon a finding that they are somehow "better off" as a result of the gifts. Before the gifts were made, these taxpayers owed nothing and by virtue of the gifts they received nothing. They were not better off after the gifts were made; they were simply not worse off, as they would have been had they

paid the gift taxes themselves. *See, Hirst v. Commissioner*, 572 F.2d at 431.

Generally, gross income means all income from whatever source derived. 26 U.S.C. § 61 (1976). However, gross income does not include the value of property acquired by gift. 26 U.S.C. § 102 (1976). Although there is no section specifically excluding value accruing to the donor of a gift, an entirely separate taxing scheme was established for gifts. 26 U.S.C. §§ 2501, *et seq.* (1976). This is a clear Congressional recognition that the transfer of property by gift is not an income producing event. By its very nature, a gift is not a transfer involving a taxable gain to the donor.

The decision by the Eighth Circuit in these cases is the first instance in which income taxes were found to be payable on a pure net gift of appreciated property. The Commissioner's arguments have been rejected in every other pure net gift case. The petitioners respectfully submit that the Eighth Circuit is wrong and that the Fourth, Fifth and Sixth Circuits, and the United States Tax Court, are right. A gift is not an income producing transaction.

These cases present an important question of tax law on which the Courts of Appeals are squarely divided. Three circuits have decided in favor of the taxpayer and one circuit has indicated its approval of these decisions. The Eighth Circuit in this case has decided in favor of the government and the Second Circuit has suggested that it would also rule in favor of the government. The other circuits have yet to rule. This split causes taxpayers in the Eighth Circuit to be subject to taxes not imposed on taxpayers carrying out identical transactions in the Fourth, Fifth and Sixth Circuits.

The net gift has been widely used as a tax and estate planning device. It has been extensively considered by the

commentators. A final determination of the income tax consequences of the net gift is needed to eliminate the present split between Circuits and to provide the basis for taxpayers reliance and planning in the future.

## IV. Conclusion

The petition for Writ of Certiorari should be granted.

Respectfully submitted,

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June 25 1981.

# APPENDIX

## APPENDIX A

UNITED STATES COURT OF APPEALS
For The Eighth Circuit

No. 80-1376

Victor P. Diedrich and Frances T. Diedrich,
*Appellees,*

v.

Commissioner of Internal Revenue,
*Appellant.*

Appeal from the United States
Tax Court

No. 80-1421
United Missouri Bank of Kansas City, N.A., Executor
of the Estate of Frances D. Grant, Deceased,
*Appellee,*

v.

Commissioner of Internal Revenue,
*Appellant.*

Appeal from the United States
Tax Court

Submitted: January 15, 1981
Filed: March 4, 1981

Before BRIGHT, STEPHENSON and McMILLIAN, Circuit Judges.

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STEPHENSON, Circuit Judge.

The Commissioner of Internal Revenue appeals from two tax court decisions[1] in favor of the taxpayer-appellees. The cases have been consolidated for argument and decision in this court. The Commissioner unsuccessfully asserted in the tax court that when a donor gratuitously transfers property on the condition that the donee pay the resultant gift tax, income accrues to the donor to the extent the amount of gift tax paid exceeds the donor's basis in the property transferred.[2] Ruling in favor of the taxpayers that no income was realized, the tax court held that the transfers were "net gifts" of the difference between the fair market value of the stock and the gift tax paid. We reverse.

The material facts in both 80-1421 and 80-1376 are undisputed. In both cases the taxpayer made a gift of low basis, highly appreciated securities to a family member.[3] The gifts were expressly conditioned on the donees' promise to pay all state and federal gift taxes arising from the transfers. Taxpayers reported no income in connection with the stock transfers. The Commissioner determined

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1. *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), *on appeal* (8th Cir. No. 80-1376); *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), *on appeal sub nom. United Missouri Bank v. Commissioner* (8th Cir. No. 80-1421).

2. The Internal Revenue Service also argues the gain is taxable in the years the gift tax was paid, rather than the years the transfer was made. Both taxpayers concede this issue, if this court determines that any taxable gain was realized.

3. In *Diedrich*, 80-1376, taxpayers transferred stock to their son outright and in trust to their son for the benefit of their daughters. In *United Missouri Bank*, 80-1376, taxpayer made the gift outright to her son.

that the transfers resulted in taxable income to the donors in the years in which the gift tax was paid.[4] The tax court held for taxpayers.

Appellant Commissioner's position is that when donors transfer highly appreciated, low basis stock subject to the condition that the donees pay the resulting gift tax, income is realized to the extent the gift tax liability exceeds the donor's basis in the transferred property. The Commissioner contends that the real and substantial economic benefit taxpayers received by having their taxes paid is a taxable accretion to wealth. Section 1001 of the Internal Revenue Code[5] provides that the gain from the sale or other

---

4. The deficiency claimed in *Diedrich*, 80-1376, is $5,959. It was computed as follows:

| | |
|---|---|
| Gift tax paid in 1972 | $ 62,992 |
| Less basis in stock transferred | 51,073 |
| Long term capital gain | 11,919 |
| 50% deduction for captial gain (I.R.C. § 1202) | 5,959 |
| Increase in taxable income | $ 5,959 |

The deficiency claim in *United Missouri Bank*, 80-1421, is $111,943.75. It was computed as follows:

| | |
|---|---|
| Gift tax paid in 1971 | $232,630.09 |
| Less basis in stock transferred | 8,742.60 |
| Long term capital gain | 223,887.49 |
| 50% deduction for capital gain (I.R.C. § 1202) | 111,943.75 |
| Increase in taxable income | $111,943.75 |

5. I.R.C. § 1001 provides:

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property. The amount realized is the sum of any money received plus the fair market value of any other property received. Because the payment of federal gift taxes is the legal responsibility of the donor,[6] the Commissioner contends that the donor realizes income in the amount of the gift taxes paid by the donee. The Commissioner relies on *Crane v. Commissioner*, 331 U.S. 1 (1947) (non-recourse mortgage is included in the basis of property and must be included in the amount realized upon sale) and *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (discharge of taxpayer's income tax liability by employer results in income to taxpayers) for the proposition that an amount realized by the taxpayer may include non-cash consideration. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.* at 729.[7]

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6. I.R.C. § 2502(d) provides:

(d) *Tax to be paid by donor.*—The tax imposed by section 2501 [the gift tax] shall be paid by the donor.

7. *See also Malone v. United States*, 326 F. Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972) (when taxpayer transferred mortgaged property to trust upon condition that trustee pay the indebtedness, taxpayer realized gain to the extent the value of property exceeded the mortgage); *First National Industries, Inc. v. Commissioner*, 26 T.C.M. (CCH) 608 (1967), *aff'd*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969) (when taxpayer gave appreciated stock subject to the condition that donee sell the stock and use the proceeds to pay the indebtedness, taxpayer realized income to the extent the obligation discharged exceeded its adjusted basis); *Simon v. Commissioner*, 32 T.C. 935 (1959), *aff'd*, 285 F.2d 422 (3d Cir. 1960) (when taxpayer transferred mortgaged building to corporation, contending he had made a contribution to capital, taxpayer realized gain to the extent the mortgage exceeded his adjusted basis).

The *Crane* doctrine has been given a great deal of discussion by the commentators. *See, e.g.*, Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277 (1978); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. Pa. L. Rev. 69 (1969); Adams, *Exploring the Outer Boundaries of the Crane Doctrine; an Imaginary Supreme Court Opinion*, 21 Tax L. Rev. 159 (1966).

Taxpayer-appellees distinguish *Crane* and *Old Colony Trust* on the basis that they involved pre-transfer realization of some portion of the appreciated value of the property. They argue these decisions have never been applied to a "pure" net gift in which the donor does not personally realize any money or other property representing any portion of the appreciated value of the property. Taxpayers rely instead on a line of cases from the tax court beginning with *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.*, 1971-2 C.B. 4, which hold that transfers identical to the ones at issue here are "net gifts"[8] which produce no taxable income to the donor.

The basic facts in *Turner* are indistinguishable from those here. Taxpayer made gifts of low basis stocks to several donees, including trusts, subject to the condition that each donee pay the gift tax which arose due to the transfer. The Commissioner of Internal Revenue asserted that the transactions constituted part sales and part gifts; that is, that they were sales to the extent that the gift tax payable exceeded the donor's basis. In his brief, however, the Commissioner conceded that the transfers to the trust were not sales, since the trustees incurred no personal liability on the gift tax. The tax court thought the distinction between the individual transfers and transfers in trust was untenable, as they were "substantially identical." 49 T.C. at 363. It treated the transfers as net gifts, based on the rationale that the donor had intended to give only

---

8. For gift tax purposes, a gift conditioned on the donee's payment of the gift tax is called a net gift. Only that portion of the value of the property transferred which exceeds the amount of gift taxes due on the transfer is considered to have been transferred with donative intent, and therefore characterized a a gift, subject to gift taxes. *Pamelo Lingo v. Commissioner*, 13 T.C.M. (CCH) 436, 441 (1954); *Sarah Helen Harrison*, 17 T.C. 1350 (1952), *acq.*, 1952-2 C.B. 2; Rev. Rul. 81-232, 1971-1 C.B. 275. This concept, of course, applies only for gift tax purposes and is not relevant to income tax consequences.

the value of the shares less the value of the gift tax payable on the transfers. In other words, the donor is said to have retained income for her own benefit from the transaction to the extent of the gift tax. Some courts have viewed the "retained interest" theory as an alternative to the economic benefit approach advanced by the Commissioner. The *Turner* rationale has been followed in all subsequent tax court decisions with similar facts. *See, e.g., Owen v. Commissioner,* 37 T.C.M. (CCH) 272 (1978), *appeal docketed,* No. 78-1341 (6th Cir.); *Estate of Henry v. Commissioner,* 69 T.C. 665 (1978); *Hirst v. Commissioner,* 63 T.C. 307 (1974), *aff'd,* 572 F.2d 427 (4th Cir. 1978) (en banc); *Estate of Davis v. Commissioner,* 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam,* 469 F.2d 694 (5th Cir. 1972).

We agree with the Commissioner that *Turner* and its progeny were incorrectly decided. As we view this problem, the correct approach was taken by *Johnson v. Commissioner,* 59 T.C. 791 (1973), *aff'd,* 495 F.2d 1072 (6th Cir.), *cert. denied,* 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner,* 72 T.C. 780 (1979), *aff'd,* 634 F.2d 12 (2d Cir. 1980). *Johnson* presents facts somewhat different than those presented here. A taxpayer borrowed $200,000 from a bank without recourse and secured the note with 50,000 shares of stock with a fair market value of $500,000 and a basis of about $11,000. Shortly thereafter the taxpayer transferred the stock to an irrevocable trust for the benefit of his children, and the trustees replaced the taxpayer's note with their own note secured by the same 50,000 shares of stock. The taxpayer paid $150,000 in gift tax from the $200,000 proceeds of the original note, leaving him $50,000 in cash. The Sixth Circuit affirmed the tax court's decision in favor of the Commissioner of Internal Revenue. It held the full value of the loan taxable on any one of three theories: (1) the $200,000 received by Johnson was gross income because

it was "income from whatever source derived"[9] and it made no difference that it was used in part to pay gift tax; (2) because section 2052(d) makes the payment of gift taxes the donor's legal obligation, the payment of that liability by the donee was equivalent to a receipt of money to the donor; (3) the principles of *Crane v. Commissioner, supra,* apply because the taxpayer actually received cash without liability to repay the notes out of his own assets. Moreover, *Johnson* stated that *Turner,* in view of the concessions made in the briefs, had "no precedential value beyond its peculiar fact situation." *Johnson v. Commissioner, supra,* 495 F.2d at 1086. The Commissioner had espoused in *Johnson,* and the tax court had accepted, the theory that the net gift was actually a "part sale and part gift," that is, that the donor sold his gift for the price of having his gift tax paid by the donee. The court emphasized that whether the transaction was called a "part gift and part sale" or a "net gift" had no import, because, regardless of terminology, the taxpayer received something of value upon the transfer. Thus, argues the Commissioner here, the broad holding of *Johnson* is that the taxpayer receives something of value upon payment by another of his obligation, and that something of value is subject to income tax.

In *Estate of Levine v. Commissioner, supra,* taxpayer made a gift of real estate encumbered by $780,000 in nonrecourse mortgages to a trust for the benefit of his three grandchildren. The donee-trust assumed the mortgage plus (1) taxpayer's obligation to pay accrued interest in the amount of $5,908.34 with respect to the mortgages, and

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9. Gross income is defined by I.R.C. § 61:

(a) *General definition.*—Except as otherwise provided in this subtitle, gross income means *all income from whatever source derived,* including (but not limited to) the following items: * * *

(emphasis added).

(2) real estate operating expenses of $125,000 for the year prior to the gift. The question presented was whether the donor realized gain to the extent the mortgage was in excess of his adjusted basis in the transferred property. Relying on *Crane* and *Old Colony Trust*, the Second Circuit (Friendly, J.) held taxable gain was realized. Although no net gift issue was involved in *Estate of Levine*, taxpayer attempted to rely on the *Turner* line of cases. In dictum the Second Circuit stated that it believed its decision consistent with *Johnson* and the *Hirst* dissent because Levine's expenses, like the gift taxes, were a personal liability of the donor. *Estate of Levine v. Commissioner*, *supra*, 634 F.2d at 17.[10] *See also Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980) (transfer of encumbered automobiles and contemporaneous assumption of liability by transferee results in gain to transferor to extent liability assumed exceeds adjusted basis in assets transferred).

Appellees attempt to distinguish *Johnson* and *Estate of Levine*. They claim first that *Johnson* must be limited to its own facts because it has not been followed in subsequent tax court cases with "pure" net gift facts,[11] or in the Fourth Circuit's *Hirst* opinion.[12]

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10. The court also stated that "[w]hile the facts in *Johnson* were peculiarly favorable to the Commissioner, we consider that it effectively overruled *Turner* as a precedent." *Estate of Levine v. Commissioner*, 634 F.2d 12, 17 (2d Cir. 1980).

11. *E.g.*, *Krause v. Commissioner*, 56 T.C. 1242 (1971); *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978); *Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978), *appeal docketed*, No. 79-1032 (6th Cir.); *Bradford v. Commissioner*, 70 T.C. 584 (1978), *appeal docketed*, No. 79-1094 (6th Cir.); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979), *appeal docketed*, No. 80-7127 (9th Cir.).

12. In *Hirst*, a mother gave three tracts of land to her son's family on the son's agreement to pay resulting gift taxes. The

(Continued on following page)

*Johnson* is further distinguished by appellees on its facts. Johnson, before making the gift, personally realized a substantial portion of the appreciated value of his stock, and he himself paid the gift tax. This is in contrast to the instant cases, in which the donee's agreement to pay the gift tax does not arise but for the net gift itself. *Estate of Levine* is similarly distinguishable on the basis that it involved a transfer of property encumbered by preexisting obligations.

We do not believe it significant that the transfers in *Johnson* and *Estate of Levine* involved preexisting encumbrances. It is a well-established principle of tax law

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Footnote continued—

tax court held the transaction was a net gift and not subject to income tax. However, the court recognized the validity of the Commissioner's position:

> *We recognize that there is much force to the Government's position.* The gift tax itself is imposed only upon the "net gift," i.e., upon the gross amount of the property transferred minus the gift tax paid by the donee. In substance, a portion of the transferred property equal in value to the amount of the gift tax is not treated as having been part of the gift. But surely that portion did not vanish into thin air, and a strong argument can be advanced for the conclusion that it was exchanged for the donee's payment of the gift tax on the "net gift," a transaction that may result in the realization of gain or loss depending upon the donor's basis in the property. If the donor had sold that portion to an outsider immediately prior to the gift of the remainder, and then used the proceeds of the sale to pay the gift tax, the practical consequences to the donor would have been the same as in *Turner*, except that the donor would have been taxable on any gain realized on the sale. *However, in the absence of any clear-cut overruling of prior law by a Court of Appeals, we are not prepared at this time to reexamine an intricate and consistent pattern of decision that has evolved over the years in this field, notwithstanding that there may be much to be said in favor of a more "realistic" approach to the problem. Things have gone too far by now to wipe the slate clean and start all over again.*

63 T.C. at 315 (emphasis added). *Hirst* was affirmed in a Fourth Circuit opinion en banc, 572 F.2d 427. The dissent vigorously asserted that *Johnson* was decided correctly and *Turner* was decided incorrectly.

that when a taxpayer constructively receives income, he is subject to income tax liability. It makes no difference whether he receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit. Nor it is relevant to our conclusion that the liability arose at the time of the transfer as opposed to before the transfer. The consequence to the donor is the same regardless of when the obligation arose.

We agree with District Judge Thomsen's dissent in *Hirst*,[13] joined by two members of the en banc court, that when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income. Here, as in *Hirst*, "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities." *Id.*, 572 F.2d at 438. As one commentator has noted, "terming the transaction a net gift does not alter the fact that despite the transferor's intention, he is actually transferring the entire property and receiving something in return. His intent that the transferee receive only a portion of the value of the property cannot eliminate that essential fact of economic life." Note, *Taxation—Conditional Net Transfers: No Income Tax Consequences to Donor—Hirst v. Commis-*

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13. Commentators have generally found the *Hirst* dissent more convincing than the majority opinions. *See, e.g.*, Note, *Taxation—Conditional Net Transfers: No Income Tax Consequences to Donor—Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), 52 Temple L. Q. 139 (1979). Comment, *Federal Income Tax—Income Taxation of Net Gifts After Hirst v. Commissioner*, 32 Rutgers L. Rev. 389 (1979); *Federal Income Tax—Net Gift Doctrine—No Taxable Income Results from Gift Given Subject to Condition that Donee Pay Gift Tax*, 63 Cornell L. Rev. 1074 (1978). *Contra*, Grier, *Recent Litigation Upholds the Favorable Treatment of the Net Gift Technique*, 48 J. of Taxation 214 (April 1978).

*sioner*, 572 F.2d 427 (4th Cir. 1978), 52 Temple L. Q. 139, 151 (1979).

We note parenthetically both taxpayers argue that they relied on a long line of tax court decisions in making these transfers, and therefore "stare decisis and fair play" require a ruling in their favor. Appellees in 80-1421 request a remand on the factual question of actual reliance should we rule against them on the legal question. In our opinion, reliance is not controlling because the income tax consequences of this type of transaction had not yet been ruled upon by this circuit at the time of the gifts in question. In any event, "Congress had indicated that, in federal tax law, claims of reliance are to be given little weight." *Gulf Inland Corporation v. United States*, 570 F.2d 1277, 1279 (5th Cir. 1978).

Accordingly, we hold that to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the property transferred, the donors realized taxable income.

The decisions of the tax court are reversed.

A true copy.

Attest:

Clerk, U.S. Court of Appeals,
Eighth Circuit

## APPENDIX B

T.C. Memo. 1980-50

UNITED STATES TAX COURT

FRANCES D. GRANT
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

Docket No. 5757-77.

Filed February 27, 1980.

*Norman E. Beal*, for the petitioner.
*Judith M. Wall* and *Gary C. Gough*, for the respondent.

### MEMORANDUM OPINION

DAWSON, *Judge*: This case was assigned to Special Trial Judge Francis J. Cantrel for the purpose of conducting the hearing and ruling on petitioner's motion for judgment on the pleadings. After a review of the record, we agree with and adopt his opinion which is set forth below.[1]

### OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, *Special Trial Judge*: Respondent in his notice of deficiency determined deficiencies in petitioner's 1970 and 1971 Federal income taxes of $41,908 and $50,237,

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1. Since this is a pretrial motion for judgment on the pleadings and there is no genuine issue of material fact, the Court has concluded that the post-trial procedures of Rule 182, Tax Court Rules of Practice and Procedure, are not applicable in these particular circumstances. This conclusion is based on the authority of the "otherwise provided" language of that Rule.

respectively. The sole issue for determination is whether petitioner realized a taxable gain upon making gifts of corporate securities to her son conditioned upon her son's paying the resulting gift tax liability.[2]

In her petition, petitioner alleged the facts in support of her claim that no deficiency exists as to her for the taxable years 1970 and 1971. Respondent filed an answer to the petition, admitting many of the alleged facts stated in the petition, and affirmatively alleging facts in support of the determined deficiencies as well as facts to support an increased deficiency for 1971 in the amount of $20,190 pursuant to section 6214(a).[3] On the basis of the facts stated in the petition and admitted by respondent in his answer, petitioner filed the present motion for judgment on the pleadings pursuant to Rule 120, Tax Court Rules of Practice and Procedure.[4] Respondent filed a "Notice of Objection to Petitioner's Motion for Judgment on the Pleadings" on the ground that petitioner did not file a reply to his answer as required by Rule 37(a), and accordingly the case could not be deemed at issue under the provisions of Rule 38. Subsequently, respondent withdrew this objection upon the filing of a reply by petitioner after the Court had granted her leave to file her reply out of time. Respondent filed a memorandum of law containing substantive objections to petitioner's motion for judgment on

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2. In his notice of deficiency, respondent also adjusted petitioner's medical expense and sales tax deduction. These automatic statutory adjustments depend entirely upon the outcome of the corporate securities gift issue.

3. Since respondent originally determined a $50,237 deficiency in his notice of deficiency, this increase results in an alleged total deficiency for 1971 in the amount of $70,427. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

4. All rule references herein are to the Tax Court Rules of Practice and Procedure.

the pleadings and a hearing was held thereon at the Motions Session in Washington, D.C.

The following facts are undisputed and are taken from those portions of petitioner's petition admitted by respondent in his answer.

Petitioner is an individual over 90 years of age having her legal residence at the time the petition herein was filed in Kansas City, Jackson County, Missouri. She filed her Federal income tax returns for 1970 and 1971 with the Internal Revenue Service at Kansas City, Missouri.

In August 1970, petitioner made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant (William), conditioned upon his paying the gift taxes shown to be due by her gift tax return. On or before April 15, 1971, petitioner filed her gift tax return for 1970 in which she reported the gift, and her son paid, upon the filing of the return, the gift taxes disclosed to be owing on the gift in the amount of $106,334.32. Petitioner's adjusted basis in these Voting Trust Certificates was $4,857.

On or before April 15, 1971, petitioner filed her individual Federal income tax return for the year 1970 and paid with or prior to filing such return the full amount of tax shown to be owing in the amount of $27,754.

In January 1971, petitioner made a gift of 40,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation to her son William, conditioned upon his paying the gift taxes shown to be due on the gift by her gift tax return. On May 20, 1971, petitioner filed her gift tax return for the first quarter of 1971 in which she reported the aforesaid gift, and her son, upon the filing of the return, paid the gift taxes disclosed to be owing on the gift in the amount of $126,295.77. Pe-

titioner's adjusted basis in these Voting Trust Certificates was $3,885.60.

On or before April 15, 1972, petitioner filed her individual Federal income tax return for 1971 and paid with or prior to filing the return the full amount of taxes shown to be owing in the amount of $7,035.

Upon audit of petitioner's income tax returns for 1970 and 1971, respondent determined that petitioner's gifts to her son William, as described above, constituted in part a sale of the Voting Trust Certificates to him. Respondent in his notice of deficiency determined that petitioner realized a long-term capital gain from the disposition of the BMA common stock in the amount that the gift tax paid by her son exceeded her adjusted basis in the property.

Here the petitioner made gifts of stock to her son which were conditioned on her son paying all applicable gift taxes, which he subsequently did pay. The gift tax liability exceeded the total amount of petitioner's basis in the transferred stock.

This case is another of a line of cases involving the net gift versus the part-gift-part-sale issue. Respondent, relying upon *Johnson v. Commissioner*, 59 T.C. 791 (1973), affd. 495 F.2d 1079 (6th Cir. 1974), characterizes the transaction as in part a sale and in part a gift. He contends that since the gift taxes on the transfer were the legal obligation of the donor petitioner, the donee son's payment constituted income which was in effect an amount realized as consideration for the transfer. Accordingly, he claims that the amount of the payment exceeding petitioner's basis in the transferred stock constituted income to her.[5]

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5. See sec. 2502(d); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

This Court first held in *Turner v. Commissioner*, 49 T.C. 356 (1968), affd. per curiam 410 F.2d 752 (6th Cir. 1969), involving facts similar to those before us, that the transfer constituted a net gift resulting in no income tax liability to the donor. This Court and others have repeatedly followed this approach of characterizing the transfer as a net gift resulting in no tax liability to the donor. *Bradford v. Commissioner*, 70 T.C. 584 (1978), on appeal (6th Cir., Dec. 26, 1978); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978), on appeal (6th Cir., May 5, 1978); *Hirst v. Commissioner*, 63 T.C. 307 (1974), affd. 572 F.2d 427 (4th Cir. 1978); *Krause v. Commissioner*, 56 T.C. 1242 (1971).[6] Inasmuch as the facts and legal questions presented here are indistinguishable from those previously addressed in these cases, we hold, for the reasons we set forth at length in *Estate of Henry v. Commissioner, supra*, and *Hirst v. Commissioner, supra*, that petitioner did not realize income as a result of her gifts of stock conditioned upon her donee son's payment of the resulting gift taxes.

Accordingly, petitioner's motion for judgment on the pleadings will be granted.[7] In accordance with the foregoing,

*An appropriate order and decision will be entered.*

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6. See also, *Estate of Weeden v. Commissioner*, T. C. Memo. 1979-498; *Diedrick v. Commissioner*, T. C. Memo. 1979-441; *Benson v. Commissioner*, T. C. Memo. 1978-231; *Estate of Davis v. Commissioner*, T. C. Memo. 1971-318, affd. per curiam 469 F.2d 694 (5th Cir. 1972).

7. In her petition and motion, petitioner requests that respondent be ordered to pay costs and attorney fees. This request is denied because this Court lacks jurisdiction to award attorney fees. *Key Buick Co. v. Commissioner*, 68 T.C. 178 (1977), on appeal (5th Cir., Aug. 15, 1977).

## APPENDIX C

Victor P. Diedrich and Frances T. Diedrich v. Commissioner. Docket No. 1800-77. T. C. Memo. 1979-441. Filed November 6, 1979.

Phillip H. Martin and Bruce J. Shnider, 2300 First Nat'l Bank Bldg., Minneapolis, Minn. for the petitioners. Burns Mossman, for the respondent.

Memorandum Findings of Fact and Opinion

Wiles, Judge: Respondent determined a deficiency of $27,831 in petitioners' 1972 Federal income tax. After concessions, the sole issue for decision is whether petitioners realized income on transfers of stock to or for the benefit of their children where the transfers were conditioned on the donees agreeing to pay Federal and state gift taxes resulting from the transfers.

Findings of Fact

All of the facts have been stipulated and are found accordingly.

Victor P. and Frances T. Diedrich, husband and wife, resided in Owatonna, Minnesota, when they timely filed their 1972 joint Federal income tax return with the Office of the Internal Revenue Service at Ogden, Utah, and when they filed their petition in this case.

On April 1, 1972, Victor P. Diedrich made a gift of 51,073 shares of voting and nonvoting common stock of Owatonna Manufacturing Company, Inc. (hereinafter OMC), to or for the benefit of his three adult children, Eugene F. Diedrich, JoAnn D. Petkus, and Madelyn D. Smith. Also, on April 1, 1972, Frances T. Diedrich made a gift of 60 shares of OMC common stock to her son,

Eugene F. Diedrich. A total of 17,025 shares, consisting of 12,903 shares of voting common stock and 4,122 shares of nonvoting common stock, was transferred outright to Eugene F. Diedrich. A total of 17,024 shares of nonvoting common stock was transferred to each of the irrevocable trusts created by Victor P. Diedrich on April 1, 1972, for the benefit of his daughters, JoAnn D. Petkus (hereinafter the Petkus Trust) and Madelyn D. Smith (hereinafter the Smith Trust). Eugene F. Diedrich was and is the sole trustee for the Petkus and Smith Trusts. Eugene F. Diedrich, the Petkus Trust, and the Smith Trust are hereinafter referred to as the Donees.

At the time the gifts were made, Eugene, for himself and as the trustee of the Petkus and Smith Trusts, signed three agreements on behalf of each of the Donees. The agreements provided that each Donee would pay its share of the Federal and state gift taxes arising from the stock transfers as a condition to receiving the gifts.

For Federal gift tax purposes, petitioners agreed to treat their gifts as if made one-half by each. On or before August 15, 1972, they reported the stock transfers by timely filing Federal gift tax returns for the second quarter of 1972.

The OMC stock transferred to the Donees was valued at $7.80 per share. The gross amount of the gift of 51,073 shares of OMC stock reported on the return was $398,369. After reducing this amount by the Federal and state gift taxes to be paid by the Donees, the net amount of the gift was determined to be $316,869. The resulting Federal gift tax liability of $62,992 on the $316,869 gift was paid by the Donees in 1972.

On or before April 15, 1973, petitioners timely filed a Minnesota gift tax return to report the gifts made in

1972. Minnesota gift taxes of $18,508 were paid by the Donees during 1973.

In order to satisfy the Federal gift tax liability, Eugene, acting in his individual capacity and as trustee of the Petkus and Smith Trusts, borrowed the sum of $62,992 from OMC. Each loan was represented by three separate checks payable to the order of the respective borrower. On or about August 15, 1972, Eugene paid the gift tax, individually and as trustee of the Trusts, by endorsing these checks to the order of the Internal Revenue Service.

To pay the principal and interest on the loans from OMC, the Petkus and Smith Trusts each sold 2,728 shares of OMC stock to OMC in December 1972 at $7.80 per share. Eugene paid the principal and interest on the loans from OMC with his personal funds.

On or before April 15, 1973, the Trusts each sold additional shares of OMC stock at $7.80 per share to pay their respective portions of the Minnesota gift tax in 1973. Eugene again used his personal funds to pay his portion of the state tax in 1973.

Upon audit of petitioners' Federal gift tax returns in 1974, the value of the OMC stock transferred to the Donees was increased from $7.80 to $13.00 per share. Accordingly, the value of the 51,073 shares was determined to be $663,949. The additional Federal and Minnesota gift taxes of $64,213 resulting from the audit were paid by the Donees in 1975.

After the audit gave rise to increased gift tax liabilities, OMC agreed to pay the Petkus and Smith Trusts additional consideration for the purchase of their stock in December 1972. This increased the purchase price to $13.00 per share and OMC also agreed to pay interest to the Trusts

from the date of sale to the date of payment of such additional consideration. Each Trust used these proceeds to pay its respective portion of the additional Federal and Minnesota gift taxes resulting from the audit. Eugene paid his portion of the additional taxes from his personal funds.

Petitioners had a basis of $1.00 per share in the OMC stock transferred to the Donees and, as of the date of the gift, had held this OMC stock longer than six months. One of the reasons they made the gift to Eugene, who is now president of OMC, was to encourage his continued participation in the business. They transferred the OMC stock in trust for the benefit of their daughters primarily to provide them with the equity interest in the family business. Eugene was made sole trustee of the daughters' trusts to ensure that majority control of the outstanding shares of OMC stock will remain in the control of the Diedrich family.

Since petitioners were cash method taxpayers, respondent conceded that the gift taxes paid by the Donees in 1973 and 1975 are not at issue in this case which involves only taxable year 1972.

On their income tax return for 1972 petitioners did not report any income by reason of the transfers of the stock. In his statutory notice respondent determined that the transfers constituted exchanges of stock giving rise to income in the form of capital gain in 1972.

## Opinion

The sole issue for decision is whether petitioners realized income on transfers of stock to or for the benefit of their children where the transfers were conditioned on the Donees agreeing to pay Federal and state gift taxes resulting from the transfers.

The basic facts are not in dispute. Petitioners made gifts of stock which had a fair market value in excess of their basis. The gifts were conditioned on the Donees paying all applicable gift taxes, which they eventually did. The gift tax liability exceeded the total amount of donors' basis in the transferred stock.

Respondent, relying upon *Johnson v. Commissioner* [Dec. 31,886], 59 T. C. 791 (1973), affd. [74-1 USTC ¶ 9355] 495 F. 2d 1079 (6th Cir. 1974), characterizes the transaction as in part a sale and in part a gift. He reasons that since the gift taxes on the transfer were the legal obligation of the donors,[1] Donees' payment constituted income which was in effect an amount realized as consideration for the transfer. This, he claims, resulted in income to the donors to the extent the payment exceeded their basis in the transferred stock.

Petitioners, relying on a long line of decisions from this Court,[2] maintain that they merely made a net gift of the difference between the fair market value of the stock and the gift tax paid. In characterizing a transaction as a net gift, we have repeatedly held that the donor does not realize income as a result of the transfer.

In each case involving facts similar to the ones before us, we have held that the transfer constituted a net gift

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1. Sec. 2502(d), I. R. C. 1954.

2. *Estate of Henry v. Commissioner* [Dec. 34,960], 69 T. C. 665 (1978), on appeal (6th Cir. May 5, 1978); *Hirst v. Commissioner* [Dec. 32,868], 63 T. C. 307 (1974), affd. [78-1 USTC ¶ 9166] 572 F. 2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner* [Dec. 31,120(M)], T. C. Memo. 1971-318, affd. per curiam [73-1 USTC ¶ 9124], 469 F. 2d 694 (5th Cir. 1972); *Turner v. Commissioner* [Dec. 28,814], 49 T. C. 356 (1968), affd. per curiam [69-1 USTC ¶ 9416] 410 F.2d 752 (6th Cir. 1969).

resulting in no income tax liability to the donor.[3] We recently followed this approach for characterizing the transaction in *Estate of Henry v. Commissioner* [Dec. 34,960], 69 T. C. 665 (1978), on appeal (6th Cir. May 5, 1978). For the reasons set forth therein, we feel compelled to once again reject respondent's position that the transaction should be treated as a part-sale part-gift.

To reflect the foregoing,

*Decision will be entered for the petitioners.*

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3. For this reason *Old Colony Trust Co. v. Commissioner* [1 USTC ¶ 408], 279 U. S. 716 (1929), as advanced by respondent, is not applicable.

## APPENDIX D

## JUDGMENTS

(Filed March 4, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1376

September Term, 1980

Victor P. Diedrich and Frances T. Diedrich,
*Appellees,*

vs.

Commissioner of Internal Revnue,
*Appellant.*

Appeal from the United States Tax Court.

This Cause came on to be heard on the record of the United States Tax Court, appendix and briefs of the respective parties and was argued.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the Tax Court in this cause be, and the same is hereby, reversed in accordance with the opinion of this Court.

| Costs taxed in favor of Appellant: | March 4, 1981 |
|---|---|
| Costs of five copies of appendix, five copies of brief and five copies of reply brief: | $204.60 |
| Total costs of Appellant for recovery from Appellees | $204.60 |

(Filed March 4, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1421

September Term, 1980

United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, Deceased,
*Appellee,*

vs.

Commissioner of Internal Revenue,
*Appellant.*

Appeal from the United States Tax Court.

This Cause came on to be heard on the record of the United States Tax Court, appendix and briefs of the respective parties and was argued.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the Tax Court in this cause be, and the same is hereby, reversed in accordance with the opinion of this Court.

| Costs taxed in favor of Appellant: | March 4, 1981 |
|---|---|
| Costs of five copies of appendix, five copies of brief and five copies of reply brief: | $203.16 |
| Total costs of Appellant for recovery from Appellee: | $203.16 |

## APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1421

September Term, 1980

United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, Deceased,
*Appellee,*

vs.

Commissioner of Internal Revenue,
*Appellant.*

Appeal from the United States Tax Court.

The Court, having considered appellee's petition for rehearing and suggestions for rehearing en banc and being now fully advised in the premises, hereby orders the petition for rehearing and suggestions for rehearing en banc denied.

March 27, 1981

(Filed March 27, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1376

September Term, 1980

Victor P. Diedrich and Frances T. Diedrich,
*Appellees,*

vs.

Commissioner of Internal Revenue,
*Appellant.*

Appeal from the United States Tax Court.

The Court having, considered appellees' petition for rehearing and suggestions for rehearing en banc and being now fully advised in the premises, hereby orders the petition for rehearing and suggestions for rehearing en banc denied.

March 27, 1981

Office - Supreme Court, U.S.
FILED
NOV 21 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-2204

# In the Supreme Court of the United States

**October Term, 1981**

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent,*

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## JOINT APPENDIX

NORMAN E. BEAL
HILLIX, BREWER, HOFFHAUS & WHITTAKER
2715 Commerce Tower
P. O. Box 13367
Kansas City, Missouri 64199
(816) 221-0355
*Counsel for Petitioners*

REX E. LEE
Solicitor General of the United States
U. S. Department of Justice
Washington, D. C. 20530
(202) 633-2217
*Counsel for Respondent*

**Petition for Certiorari Filed June 25, 1981**
**Certiorari Granted October 5, 1981**

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, (816) 421-3030

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**GENERAL DOCKET**

UNITED STATES TAX COURT

Docket No. 5757-77

FRANCES D. GRANT, 824 BMA Tower, One Penn Valley, Kansas City, Missouri 64141,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE
Respondent.

| | |
|---|---|
| June 9, 1977 | PETITION FILED: FEE PAID June 9, 1977. |
| June 9, 1977 | REQUEST by Petr. for trial at Kansas City, Missouri. |
| June 17, 1977 | ENTRY OF APPEARANCE by Norman E. Beal as counsel for petr. filed. |
| Jul. 1, 1977 | ENTRY OF APPEARANCE by Oscar S. Brewer as counsel for petr. filed. |
| Jul. 21, 1977 | ANSWER by Resp. filed. |
| Sep. 22, 1977 | MOTION by Petr. for Judgment on the Pleadings. (C/S 9/19/77) |
| Sep. 22, 1977 | BRIEF in Support of Motion for Judgment on the Pleadings filed by Petr. (C/S 9/19/77) |
| Sept. 23, 1977 | NOTICE of hearing Nov. 9, 1977 at Washington, DC on Petr. motion filed Sept. 22, 1977. |
| Nov. 4, 1977 | NOTICE OF OBJECTION by Resp. to Petr's. Motion for Judgment on the Pleadings, filed. |

| | |
|---|---|
| Nov. 4, 1977 | MOTION by Resp. for leave to file a Motion for entry of order that undenied allegations in Answer be deemed admitted out of time. (Motion under Rule 37(c) Lodged) |
| Nov. 4, 1977 | MOTION by Resp. for continuance of hearing on Petr's. Motion filed Sept. 22, 1977 to Jan. 4, 1978 at Washington, D.C. |
| Nov. 7, 1977 | ORDER that resp. motion for continuance filed Nov. 4, 1977 is granted in that the hearings on petr's. pending motion for judgment on the pleadings is continued to the Motions Session on Jan. 11, 1978 at Washington, D.C. It is further |
| | ORDER that resp's. motion for leave to file Rule 37 Motion out of time filed Nov. 4, 1977 is also calendared for hearing on Jan. 11, 1978 Motions Session at Washington, D.C. |
| Dec. 5, 1977 | REPLY by Petitioner filed. (Leave to file Granted) |
| Dec. 22, 1977 | AMENDMENT TO NOTICE OF OBJECTION to petr's. motion for judgment on the pleadings filed by resp. |
| Dec. 22, 1977 | MEMORANDUM OF LAW filed by resp. |
| Jan. 10, 1978 | SUPPLEMENTAL STATEMENT filed by petr. in support of petr's. motion for judgment on the pleadings. (C/S 1-6-78) |
| Jan. 11, 1978 | HEARING at Washington, DC before Special Trial Judge Cantrel. Petr. motion filed 9/22/77. See Order 2-28-80. |

| | |
|---|---|
| Jan. 13, 1978 | TRANSCRIPT of Jan. 11, 1978 received. |
| Feb. 27, 1980 | ORDER that case is *reassigned to Judge Dawson.* |
| Feb. 27, 1980 | MEMORANDUM OPINION Filed, Judge Dawson. An appropriate order and decision will be entered. |
| Feb. 28, 1980 | ORDER that petr's. motion filed Sep. 22, 1977 is granted. It is further |
| | DECISION ENTERED, Judge Dawson. |
| | APPELLATE PROCEEDINGS |
| May 27, 1980 | NOTICE OF APPEAL to U.S.C.A., Eighth Circuit, filed by Respondent. |
| May 28, 1980 | NOTICE of Filing with copy of notice of appeal mailed to Mr. Albert F. Hillix, counsel for petitioner. |
| May 28, 1980 | NOTICE, to parties, of assembling and date for transmission of the record. |

(Caption Omitted)

**PETITION (Docket No. 5757-77)**

(Filed June 9, 1977)

Petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his Notice of Deficiency, I.R.S. Symbol No. RC:MW:DIR:STL: jh(kcy), dated March 10, 1977 and, as the basis for her case, alleges as follows:

1. Petitioner is an individual with legal residence in Kansas City, Jackson County, Missouri. The return for the period here involved was filed with the Office of the Internal Revenue at Kansas City, Missouri.

2. The Notice of Deficiency (a copy of which, including so much of the statement and schedule accompanying the notice as is material, is attached and marked Exhibit A) was mailed to the petitioner on March 10, 1977, and was issued by the Office of the Internal Revenue Service at P. O. Drawer 1458, Central Station, St. Louis, Missouri 63188.

3. The deficiencies determined by the Commissioner are in income taxes for calendar years 1970 and 1971, in the amounts of $41,908 and $50,237 respectively, all of which is in dispute.

4. The determination of tax set forth in said Notice of Deficiency is based upon the following errors:

(a) that petitioner's net gifts of securities to her son in 1970 and 1971 constituted in part gifts and in part sales, with the result that petitioner realized capital gain to the extent the gift taxes assumed and paid by the donee exceeded her basis in the securities;

(b) that the capital gain, if any, realized by petitioner upon the net gift of securities to her son in 1970 was recognized by her in 1970 upon the making of said gift, rather than in 1971 upon payment of the gift taxes by the donee;

(c) that the deficiency, if any, for the petitioner's tax year ending December 31, 1970, was not barred by the applicable statute of limitations;

(d) that the Commissioner is not estopped to assert the part-gift, part-sale theory mentioned in (a) above because of petitioner's reliance upon the previous case law and the Regulations and Rulings of the Commissioner concerning net gifts;

(e) that the amount of the gift tax liability assumed and paid by petitioner's son, the donee, for petitioner's net gift in 1970 was $148,753.55 when in fact said amount was $106,334.32; and

(f) that the amount of the gift tax liability assumed and paid by petitioner's son, the donee, for petitioner's net gift in 1971 was $166,914.03 when in fact said amount was $126,295.77.

5. The facts upon which petitioner relies as the basis of her case are as follows:

(a) Petitioner is over 90 years old and has for many years made sizeable gifts to her children. No part of these gifts was ever intended as a sale.

(b) On August 19, 1970, petitioner made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant. This was a net gift conditioned upon the donee paying the gift tax shown to be due by petitioner's gift tax return. On or before April 15, 1971, petitioner filed her gift tax return for 1970, reporting the aforesaid net gift, and the donee paid, upon the filing of said return, the gift taxes disclosed to be owing for said net gift in the amount of $106,334.32. The petitioner's adjusted basis in these Voting Trust Certificates was $4,857.00.

(c) On or before April 15, 1971, and within the time required by law, petitioner filed her United States Individual Income Tax Return for the year 1970 and paid with or prior to filing such return the full amount of taxes shown to be owing, to wit: $27,754.00.

(d) On January 11, 1971, petitioner made a gift of 40,000 Class "A" Voting Trust Certificates, represent-

ing common stock of BMA Corporation, to her son William D. Grant. This was a net gift conditioned upon the donee paying the gift tax shown to be due by petitioner's gift tax return. On May 20, 1971, petitioner filed her gift tax return for the first quarter of 1971 reporting the aforesaid net gift and the donee paid, upon the filing of said return the gift taxes disclosed to be owing for said net gift in the amount of $126,295.77. The petitioner's adjusted basis in these Voting Trust Certificates was $3,885.60.

(e) On or before April 15, 1972, and within the time required by law, petitioner filed her United States Individual Income Tax Return for the year 1971 and paid with or prior to filing such return the full amount of taxes shown to be owing, to wit: $7,035.00.

(f) Upon audit of petitioner's income tax returns for 1970 and 1971, the Commissioner determined that petitioner's gifts to her son, as described above, constituted in part a sale of the property to him. On the basis of such determination, the Commisisoner proposed deficiencies in petitioner's 1970 and 1971 income taxes in the respective amounts of $41,908.00 and $50,237.00, plus interest on said deficiencies through March 15, 1977 in the respective amounts of $16,065.00 and $16,243.83.

(g) Petitioner intended all of the Voting Trust Certificates transferred by her to her son on August 19, 1970, and on January 11, 1971, to be net gifts to him; neither of said transfers, in whole or in part, was intended as a sale of the Voting Trust Certificates to petitioner's son. The petitioner's income tax returns, as filed, for the years 1970 and 1971 correctly reported her income.

(h) The due date of the 1970 federal income tax return of petitioner was April 15, 1971. Said return was filed prior to that date. Petitioner has not given any waivers staying the running of the applicable statute of limitations with regard to the 1970 return. The Notice of Deficiency is dated March 10, 1977.

WHEREFORE, Petitioner prays that this Court may hear this proceeding and determine that no deficiency exists as to her for the taxable years 1970 and 1971, and that petitioner should recover her costs and attorneys' fees in this action.

By /s/ Albert F. Hillix
By /s/ Oscar S. Brewer
By /s/ Norman E. Beal
Hillix, Brewer, Hoffhaus & Whittaker
2715 Commerce Tower
P. O. Box 13367
Kansas City, Missouri 64199
(816) 221-0355
Attorneys for Petitioner

Dated: June 7, 1977

# Exhibit A

Internal Revenue Service
District Director
RC:CW:DIR:STL:jh(kcy)
Certified Mail #510128

Date: MAR 10 1977

Internal Revenue Service
P. O. Drawer 1450
Central Station
St. Louis, Missouri 63188

MAR 11 1977 U. S.
Department of the Treasury

- 9 -

Tax Year Ended and Deficiency:
12/31/70 $41,908.00
~~Person to Contact:~~
12/31/71 50,237.00
~~Contact Telephone Number:~~
Person to Contact:
K. Francis
Contact Telephone Number:
1-800-392-4200 (toll free)

Frances D. Grant
824 RMA Tower, One Penn Valley
Kansas City, Missouri 64141

This letter is a NOTICE OF DEFICIENCY—as required by law—that we have determined the income tax deficiencies shown above. We regret we have been unable to reach a satisfactory agreement in your case. The enclosed statement shows how the deficiencies were computed.

If you do not intend to contest this determination in the United States Tax Court, please sign and return the enclosed waiver form. This will permit an early assessment of the deficiencies and limit the accumulation of interest. The enclosed self-addressed envelope is for your convenience.

If you decide not to sign and return the waiver, the law requires that after 90 days from the date of mailing this letter (150 days if this letter is addressed to you outside the United States) we assess and bill you for the deficiencies. However, if within the time stated you contest this determination by filing a petition with the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217, we may not assess any deficiencies and bill you until after the Tax Court has decided your case. You can obtain a copy of the rules for filing a petition by writing to the Clerk of the Tax Court at the Court's Washington, D.C. address stated above.

If you intend to file a petition with the United States Tax Court, you must do so within the time stated above (90 or 150 days, as the case may be); this period is fixed by law, and the Court cannot consider your case if your petition is filed late.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely yours,

William E. Williams
~~Commissioner~~
Commissioner
By R.C. Voskuil

Enclosures:
Statement
Waiver
Envelope

| Form 4089 (Rev. November 1974) | Department of the Treasury - Internal Revenue Service<br>Statutory Notice Statement - Waiver | Symbols<br>RC:MW:DIR:STL:jh(key) |
|---|---|---|

Name and Address of Taxpayer(s)

- 10 -

Frances D. Grant
824 EMA Tower, One Penn Valley
Kansas City, MO 64141

| Kind of Tax | ☒ Copy to Authorized Representative | Thomas L. McKittrick<br>P.O. Box 13406<br>Kansas City, MO 64199 |
|---|---|---|
| Income | | |
| Taxable Year Ended | Deficiency (Increase in Tax and Penalties) | |
| 12/31/70 | $41,908.00 | |
| 12/31/71 | 50,237.00 | |

See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

| Spouse | | | |
|---|---|---|---|
| | ▶ | | Date |
| | ▶ | | Date |
| | By ▶ | Title | Date |

Note:

If you consent to the assessment of the amounts shown in this waiver, please sign and return the form in order to limit the accrual of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled; nor prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for other action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court.

Who Must Sign

If you filed jointly, both you and your spouse must sign. If the taxpayer is a corporation this waiver must be signed with the corporate name followed by the signatures and titles of the officers authorized to sign.

Your attorney or agent may sign this waiver provided his action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee), Form 56, Notice of Fiduciary Relationship, should, unless previously filed, accompany this form.

If you agree, please sign one copy and return it; keep the other copy for your records.

Form 9459
January 1975 | Statement - Income Tax Changes | 2010 | A

Name of Taxpayer(s)

Frances D. Grant - 11 -

☑ Notice Deficiency ☐ Other (specify)
☐ Settlement Computation

| | Tax Years Ended 12-31-70 | 12-31-71 | |
|---|---|---|---|
| 1. Adjustments to income | | | |
| a. Gain from Disposition of Capital Asset | $71,948.00 | $81,514.00 | |
| b. Medical Expense Deduction | | 2,445.00 | |
| c. Sales Tax Deduction | (45.00) | (62.00) | |
| d. | | | |
| e. | | | |
| f. | | | |
| g. | | | |
| 2. Total adjustments | 71,903.00 | 83,897.00 | |
| 3a. ☑ Taxable income ☐ Adjusted gross income<br>b. As shown in: ☐ Preliminary letter dated ____ ☐ Notice of deficiency dated ____ ☑ Return as filed | 58,410.00 | 24,612.00 | |
| 4. ☐ Taxable income as revised<br>☐ Adjusted gross income as revised | 130,313.00 | 108,509.00 | |
| 5. Tax | | | |
| 6. Alternative tax if applicable (from page 2 ) | 67,975.00 | 57,272.00 | |
| 7. Tax surcharge | 1,699.00 | | |
| 8. Corrected tax liability (Lesser of line 5 or 6, plus line 7) | 69,674.00 | 57,272.00 | |
| 9. Less credits (specify) a. Retirement Income Credit | 12.00 | | |
| b. | | | |
| c. | | | |
| 10. Balance (line 8 less amounts on lines 9a through 9c) | 69,662.00 | 57,272.00 | |
| 11. Plus a. Tax from recomputing prior year investment credit | | | |
| b. Self-employment tax | | | |
| c. | | | |
| 12. Total corrected income tax liability (line 10 plus amounts on lines 11a through 11c) | 69,662.00 | 57,272.00 | |
| 13. Total tax shown on return or as previously adjusted | 27,754.00 | 7,035.00 | |
| 14. Statutory deficiency or overassessment (difference between lines 12 and 13) | 41,908.00 | 50,237.00 | |
| 15. Additions to the tax (listed below) | | | |

Form 5278 (1-75)

Form 4512 C (Dec. 1969)

INCOME TAX AUDIT MANUAL

COMPUTATION OF ALTERNATIVE TAX — NONCORPORATE TAXPAYERS

NAMES OF TAXPAYERS

Frances D. Grant - 12 -

IDENTIFYING NUMBER

487-30-6247

| | | Year: 12-31-70 | 12-31-71 |
|---|---|---|---|
| PART I Complete for all years | 1. CORRECTED TAXABLE INCOME (from line 4, page 13) | 130,313.00 | 108,309.00 |
| | 2. LESS: 50% OF EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS | 71,948.00 | 81,314.00 |
| | 3. BALANCE | 58,365.00 | 26,995.00 |
| | 4. EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS (line 2 multiplied by 2) | 143,896.00 | 163,028.00 |
| | 5. TAX ON AMOUNT ON LINE 3 | 27,776.00 | 8,038.00 |
| | 6. a. FOR 1969 AND PRIOR YEARS — 25% OF LINE 4<br>b. FOR 1970 AND SUBSEQUENT YEARS, IF LINE 4 NOT OVER $50,000* — 25% OF LINE 4<br>c. FOR 1970 AND SUBSEQUENT YEARS, IF LINE 4 EXCEEDS $50,000* — AMOUNT FROM LINE 18 FOR 1970 AND 1971 AND AMOUNT FROM LINE 14 FOR LATER YEARS | 40,199.00 | 49,234.00 |
| | 7. ALTERNATIVE TAX (add lines 5 and 6) | 67,975.00 | 57,272.00 |
| PART II Complete only for 1970 and subsequent years when line 4 above exceeds $50,000* (for 1970 and 1971, also complete Part III) | 8. AMOUNT FROM LINE 4 ABOVE | 143,896.00 | 163,028.00 |
| | 9. LONG-TERM CAPITAL GAINS (section 1201(d)(3))** | 50,000.00 | 50,000.00 |
| | 10. 25% OF THE LESSER OF LINE 8 OR LINE 9 | 12,500.00 | 12,500.00 |
| | 11. TAX ON LARGER OF LINE 1 OR LINE 3 | 76,709.00 | 59,046.00 |
| | 12. TAX AT ORDINARY RATE ON SUM OF LINE 3 PLUS ½ OF LINE 9 | 44,078.00 | 21,427.00 |
| | 13. LINE 11 LESS LINE 12 (if less than zero, enter zero) | 32,631.00 | 37,619.00 |
| | 14. ADD LINES 10 AND 13 (see line 14 below) | 45,131.00 | 50,119.00 |
| PART III Complete for years 1970 and 1971 if line 4 above exceeds $50,000* | 15. a. FOR 1970 — 29½% OF LINE 8 LESS LINE 9<br>b. FOR 1971 — 32½% OF LINE 8 LESS LINE 9 (if less than zero, enter zero) | 27,699.00 | 36,734.00 |
| | 16. AMOUNT FROM LINE 10 ABOVE | 12,500.00 | 12,500.00 |
| | 17. ADD LINES 15 AND 16 | 40,199.00 | 49,234.00 |
| | 18. LESSER OF AMOUNTS ON LINES 14 OR 17 (enter on line 6(c) above) | 40,199.00 | 49,234.00 |

* $25,000 if married filing separately.

** Long-term capital gains from (1) certain binding contracts, distributions and installment sales, and (2) more complex [illegible] of the excess of $50,000 ($25,000 married filing separately) over the gains from the binding contracts, etc.

Form 4512 C (12-70)

| FORM 886-A FEBRUARY 1969 | EXPLANATION OF ITEMS | FOLIO 3 |
|---|---|---|
| NAME OF TAXPAYER Frances D. Grant | - 13 - | YEAR ENDED 12-31-70 12-31-71 |

(a) It is determined that you realized a long term capital gain from the disposition of Business Men's Assurance Company's stock in the amount that the gift tax assumed by the donee exceeded your adjusted basis in the donated property. The gain is taxable income subject to the 50 per cent deduction provided by section 1202 of the Internal Revenue Code. (See computation below.)

| | |
|---|---|
| 1970 | |
| Gift tax liability assumed on 50,000 shares of BMA stock transferred in August 1970 | $148,753.55 |
| Adjusted basis in the stock | 4,857.00 |
| Net Long Term Capital Gain | $143,896.55 |
| Section 1202 Deduction | 71,948.28 |
| Net Gain, as corrected | $71,948.27 |
| 1971 | |
| Gift tax liability assumed on 40,000 shares of BMA stock transferred in January 1971 | $166,914.03 |
| Adjusted basis in the stock | 3,885.60 |
| Net Long Term Capital Gain | $163,028.43 |
| Section 1202 Deduction | 81,514.22 |
| Net Gain, as corrected | $81,514.21 |

(b) It is determined that, due to the increase in the amount of your adjusted gross income, a medical expense deduction of $8,260.00 is allowed in lieu of $10,705.00 claimed on your income tax return; therefore, your taxable income is increased in the amount of $2,445.00. (See attached schedule on Form 4109 for the computation.)

| FORM 886-A FEBRUARY 1969 | EXPLANATION OF ITEMS | SCHEDULE 4 |
|---|---|---|
| NAME OF TAXPAYER | | YEAR, PERIOD ENDED |
| Frances D. Grant | - 14 - | 12-31-70<br>12-31-71 |

(c) Due to the increase in your adjusted gross income in 1970 and 1971, a sales tax deduction of $311.00 for 1970 and 1971 is allowable in lieu of $266.00 claimed in 1970 and $249.00 claimed in 1971. Therefore, your taxable income is decreased $45.00 in 1970 and $62.00 in 1971.

## COMPUTATION O- MEDICAL EXPENSE ADJUSTMENT - 19 -

STATEMENT SCHEDULE 5

NAME: Frances D. Grant

| | TAX YEAR ENDED 1971 | | |
|---|---|---|---|
| 1. INSURANCE PREMIUMS FOR MEDICAL CARE (Not to exceed $150.00) | $ 33.00 | | |
| 2. COST OF MEDICINES AS SHOWN ON RETURN OR AS PREVIOUSLY DETERMINED | $ - | | |
| 3. ADJUSTMENT (See explanation below) | - | | |
| 4. COST OF MEDICINES AS NOW DETERMINED | - | | |
| 5. LESS: 1 OF ADJUSTED GROSS INCOME AS SHOWN ON RETURN OR AS REVISED | 1,501.00 | | |
| 6. BALANCE | -0- | | |
| 7. OTHER MEDICAL EXPENSES AS SHOWN ON RETURN OR AS PREVIOUSLY DETERMINED | 12,730.00 | | |
| 8. ADJUSTMENT (See explanation below) | - | | |
| 9. OTHER MEDICAL EXPENSES AS NOW DETERMINED (exclude balance of insurance premiums not included on line 1) | 12,730.00 | | |
| 10. TOTAL (line 4 plus line 9) | 12,730.00 | | |
| 11. LESS: 3% OF ADJUSTED GROSS INCOME AS SHOWN ON RETURN OR AS REVISED | 4,503.00 | | |
| 12. BALANCE | 8,227.00 | | |
| 13. MEDICAL DEDUCTION ALLOWABLE (line 1 plus line 12) | 8,260.00 | | |
| 14. MEDICAL DEDUCTION AS SHOWN ON RETURN OR AS PREVIOUSLY ALLOWED | 16,705.00 | | |
| 15. ADJUSTMENT (INCREASE) (DECREASE) | 2,445.00 | | |

### ADJUSTED GROSS INCOME AS REVISED

| | | | |
|---|---|---|---|
| 16. ADJUSTED GROSS INCOME AS SHOWN ON RETURN OR AS PREVIOUSLY DETERMINED | 68,584.00 | | |
| 17. ADD ITEMS A SCHEDULE 1 | 81,514.00 | | |
| 18. DEDUCT ITEMS SCHEDULE | - | | |
| 19. ADJUSTED GROSS INCOME AS REVISED | 150,098.00 | | |

EXPLANATION OF ADJUSTMENTS

(Caption Omitted)

**ANSWER (Docket No. 5757-77)**

(Filed July 21, 1977)

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

1., 2. and 3. Admits the allegations of paragraphs 1, 2 and 3 of the petition.

4. (a) to (f), inclusive. Denies the allegations of subparagraphs (a) to (f), inclusive, of paragraph 4 of the petition.

5. (a) Admits the petitioner is over ninety years old; denies the remaining allegations of subparagraph (a) of paragraph 5 of the petition.

(b) Admits that in August of 1970, petitioner made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant; that this was a gift conditioned upon the donee paying the gift tax shown to be due by petitioner's gift tax return; that on or before April 15, 1971, petitioner filed her gift tax return for 1970, reporting the aforesaid gift, and the donee paid, upon the filing of said return, the gift taxes disclosed to be owing for said gift in the amount of $106,334.32; and that the petitioner's adjusted basis in these Voting Trust Certificates was $4,857.00; denies the remaining allegations of subparagraph (b) of paragraph 5 of the petition.

(c) Admits the allegations of subparagraph (c) of paragraph 5 of the petition.

(d) Admits that on January 11, 1971, petitioner made a gift of 40,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant; that this was a gift conditioned upon the donee paying the gift tax shown to be due by petitioner's gift tax return; that on May 20, 1971, petitioner filed her gift tax return for the first quarter of 1971 reporting the aforesaid gift and the donee paid, upon the filing of said return the gift taxes disclosed to be owing for said gift in the amount of $126,295.77; and that the petitioner's adjusted basis in these Voting Trust Certificates was $3,885.60; denies the remaining allegations of subparagraph (d) of paragraph 5 of the petition.

(e) Admits the allegations of subparagraph (e) of paragraph 5 of the petition.

(f) Admits the allegations of subparagraph (f) of paragraph 5 of the petition, except it is denied that the Commissioner proposed interest on said deficiencies through March 15, 1977, in the respective amounts of $16,065.00 and $16,243.88.

(g) Denies the allegations of subparagraph (g) of paragraph 5 of the petition.

(h) Admits the allegations of subparagraph (h) of paragraph 5 of the petition.

6. FURTHER ANSWERING the petition, and as a defense to the assignment of error that the statute of limitations bars the assessment of the deficiency in income tax determined by the respondent for the taxable year 1970, the respondent alleges that the income tax due from the petitioner for the taxable year 1970 may be timely assessed under the provisions of *Int. Rev. Code of 1954*, § 6501(e)(1)(A) [hereinafter cited as *Code*], in support of which the respondent alleges:

(a) The amount of gross income stated in the income tax return for the taxable year 1970 was $104,016.00, consisting of the following:

| | |
|---|---|
| Dividend Income | $102,090.00 |
| Interest Income | 722.00 |
| Pension Income | 15.00 |
| Trust Income | 1,189.00 |
| Gross Income Stated in Return | $104,016.00 |

(b) In addition thereto, the petitioner realized a long-term capital gain in the amount of $71,948.27, which was not included in the gross income stated in the return filed by the petitioner for said year, and there was not disclosed on the return or in a statement attached thereto the fact that this amount was received during said year.

(c) The $71,948.27 was properly includable in gross income for the taxable year 1970 as earned income.

(d) The $71,948.27 of gross income omitted from the income tax return for the taxable year 1970 is in excess of the twenty-five percent of the gross income stated in said return.

(e) The statutory notice determining the deficiency in income tax against the petitioner for the taxable year 1970 was sent to the petitioner by certified mail on March 10, 1977, which date was prior to the expiration of the six-year period of limitations applicable under *Code* § 6501(e)(1)(A).

7. FURTHER ANSWERING the petition, and in the alternative to the determination that the petitioner realized a long-term capital gain from the disposition of BMA stock in the amount that the gift tax liability assumed by

the donee exceeded the petitioner's adjusted basis in the donated property, the respondent alleges:

(a) In April, 1971, petitioner's son William D. Grant paid gift taxes in the amount of $106,334.32 on the transfer of 50,000 Voting Trust Certificates of BMA Corporation transferred from the petitioner to William D. Grant in August, 1970.

(b) The petitioner's adjusted basis in the 50,000 Voting Trust Certificates of BMA Corporation was $4,857.00, resulting in a net gain to the petitioner upon the payment of the gift tax liability by William D. Grant of $101,477.32.

(c) In May, 1971, petitioner's son William D. Grant paid gift taxes in the amount of $126,295.78 on the transfer of 40,000 Voting Trust Certificates of BMA Corporation transferred from the petitioner to William D. Grant in January of 1971.

(d) The petitioner's adjusted basis in the 40,000 Voting Trust Certificates of BMA Corporation transferred in January, 1971, was $3,885.60, resulting in a net gain to to the petitioner upon the payment of the gift tax liability by William D. Grant of $122,410.18.

(e) Petitioner's net long-term capital gain resulting from the payment of the gift tax liability in 1971, relative to the transfer of 90,000 BMA Voting Trust Certificates referred to in the above subparagraphs (a) to (d), inclusive, is $223,887.50.

(f) The net long-term capital gain of $223,887.50 referred to above in subparagraph (e) is taxable income subject to the fifty percent deduction provided by *Code* § 1202. The net gain, as corrected, is $111,943.75.

(g) Due to the increase of petitioner's adjusted gross income for taxable year 1971 in the amount of $111,943.75, a medical expense deduction of $7,347.00 is allowed in lieu of $10,705.00 claimed on petitioner's tax return. Accordingly, the petitioner's taxable income is increased in the amount of $3,358.00 for taxable year 1971.

(h) Due to the increase in petitioner's adjusted gross income in 1971 in the amount of $111,943.75, a sales tax deduction of $311.00 is allowed in taxable year 1971 in lieu of the sales tax deduction of $266.00 claimed in the petitioner's return for taxable year 1971. Therefore, petitioner's taxable income is decreased $62.00 in taxable year 1971.

(i) Due to the adjustments set forth in the above subparagraphs (e) to (h), inclusive, the petitioner is subject to a statutory deficiency for taxable year 1971 in the amount of $70,427.00.

WHEREFORE, it is prayed:

(1) That the relief sought by the petitioner be denied;

(2) That the deficiencies in income taxes for the taxable years 1970 and 1971, as set forth in the statutory notice, be in all respects approved;

(3) That the Court determine that the assessment and collection of the deficiency in income tax for the taxable year 1970, as set forth in the statutory notice of deficiency, is not barred by the statute of limitations; and

(4) That, in the alternative, the Court redetermine the deficiency in income tax for the taxable year 1971 to be in the amount determined by the respondent, namely, $50,237.00, plus an increased deficiency in income tax for the taxable year 1971 in the amount of $20,190.00, claim

for which is hereby made pursuant to the provisions of *Code* § 6214(a).

Stuart E. Seigel
Chief Counsel
Internal Revenue Service
By: (Signed) James T. Finlen, Jr.
Assistant Regional Counsel

Date: July 19, 1977

Of Counsel:

Frank C. Conley
Regional Counsel
Gary C. Gough
Attorney
Internal Revenue Service
2700 Federal Office Building
911 Walnut Street
Kansas City, Missouri 64106
Tel. No. (816) 374-3556

(Caption Omitted)

**MEMORANDUM OPINION (Docket No. 5757-77)**

(Filed February 27, 1980)

[The Memorandum Opinion of the Tax Court in this case is reproduced at pages A12 through A16 of the Appendix to the Petition for a Writ of Certiorari in this case.]

(Caption Omitted)

**ORDER AND DECISION (Docket No. 5757-77)**

(Filed February 28, 1980)

Pursuant to the determination of the Court, as set forth in its Memorandum Opinion, filed February 27, 1980, it is

ORDERED: That petitioner's motion for judgment on the pleadings, filed September 22, 1977, is granted, and it is

ORDERED AND DECIDED: That there are no Federal income tax deficiencies due from the petitioner for the taxable years 1970 and 1971.

/s/ Howard A. Dawson, Jr.
Judge

Entered: February 28, 1980

(Caption Omitted)

**NOTICE OF APPEAL (Docket No. 5757-77)**

(Filed May 27, 1980)

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Eighth Circuit from the decision of this Court entered in the above-captioned proceeding of the 28th day of February, 1980.

Petitioner resided in Kansas City, Missouri at the time she filed her petition with the Tax Court. Accordingly, venue is properly placed with the United States Court of Appeals for the Eighth Circuit.

(Signed) M. Carr Ferguson/J. H. Jr.
Assistant Attorney General
Department of Justice
(Signed) N. Jerold Cohen/J. H. Jr.
Chief Counsel
Internal Revenue Service

Dated: May 27, 1980

## GENERAL DOCKET

UNITED STATES TAX COURT

Docket No. 1800-77

VICTOR P. DIEDRICH AND FRANCES T. DIEDRICH,
530 Academy St., Owatonna, MN 55060,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

| | |
|---|---|
| Feb. 28, 1977 | PETITION FILED: FEE PAID Feb. 28, 1977. |
| Feb. 28, 1977 | REQUEST by Petr. for trial at St. Paul, MN filed. |
| March 24, 1977 | ENTRY OF APPEARANCE by Nicky R. Hay as counsel for petr. filed. |
| April 11, 1977 | ANSWER by Resp. filed. |
| Feb. 14, 1978 | NOTICE OF TRIAL on May 22, 1978 at St. Paul, MN. |
| May 22, 1978 | HEARING at St. Paul, MN before Judge Wiles.<br>Stipulation of Facts with Exhibits.<br>ORIGINAL BRIEFS DUE: July 21, 1978.<br>REPLY BRIEFS DUE: Sept. 19, 1978.<br>SUBMITTED TO JUDGE WILES. |
| Jun. 13, 1978 | TRANSCRIPT of May 22, 1978 received. |
| Jul. 21, 1978 | ENTRY OF APPEARANCE by Bruce J. Shnider for Petr. |
| Jul. 21, 1978 | BRIEF for Resp. filed. |

| | |
|---|---|
| Jul. 25, 1978 | BRIEF for Petr. filed. (PM Timely) |
| Sep. 19, 1978 | REPLY BRIEF filed by Resp. |
| Sep. 25, 1978 | REPLY BRIEF for Petrs. filed. (PM Timely) |
| Nov. 6, 1979 | MEMORANDUM FINDINGS OF FACT AND OPINION filed, Judge Wiles. Decision will be entered for Petr. |
| Nov. 13, 1979 | DECISION ENTERED, Judge Wiles. |
| Dec. 12, 1979 | MOTION by Resp. to Vacate Decision in order to permit entry of decision under Rule 155. |
| Dec. 12, 1979 | MOTION by Resp. for leave to file Motion to Revise Opinion and permit entry of Decision under Rule 155 out of time. (Motion to Revise Opinion and permit entry of Decision under Rule 155 Lodged) |
| Dec. 17, 1979 | MOTION by Resp. to Revise Opinion and Permit Entry of Decision under Rule 155. |
| Dec. 17, 1979 | ORDER that Resp's motions filed Dec. 12, 1979 and Dec. 17, 1979 are granted, and the decision entered on Nov. 13, 1979 is vacated and set aside. Further<br>ORDERED that Court's Memorandum Findings of Fact and Opinion filed Nov. 6, 1979 is amended re: "Decision will be entered for the Petr." is changed to "Decision will be entered under Rule 155." |
| Feb. 11, 1980 | AGREED COMPUTATION filed. |
| Feb. 13, 1980 | DECISION ENTERED, Judge Wiles. |

APPELLATE PROCEEDINGS

| | |
|---|---|
| May 12, 1980 | NOTICE OF APPEAL to U.S.C.A., Eighth Circuit, filed by Respondent. |
| May 13, 1980 | NOTICE of Filing with copy of notice of appeal mailed to Mr. Phillip H. Martin, counsel for petitioners. |
| May 13, 1980 | NOTICE, to parties, of assembling and date for transmission of the record. |

(Caption Omitted)

**PETITION (Docket No. 1800-77)**

(Filed February 28, 1977)

The petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, bearing symbols AP:STP:RJW:BJC:cab, dated November 30, 1976, and as the basis for their case allege as follows:

1. The petitioners are individuals, husband and wife, with legal residence now at 530 Academy Street, Owatonna, Minnesota 55060. The return for the period here involved was filed with the Office of the Internal Revenue Service at Ogden, Utah.

2. The notice of deficiency (a copy of which, including so much of the statement and schedules accompanying the notice as is material, is attached and marked Exhibit A) was mailed to the petitioners on November 30, 1976, and was issued by the Office of the Internal Revenue Service at St. Paul, Minnesota.

3. The deficiency as determined by the Commissioner is in income tax for the calendar year 1972, in the amount of $27,831, of which $27,231 is in dispute.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

A. The Commissioner erred in determining that the petitioners realized long-term capital gain in the amount of $47,320, or any other types or amount of income, in 1972 as the result of their gift of 51,073 shares of stock of Owatonna Manufacturing Company, Inc. (with a basis to petitioners of $1 per share) to their son and to trusts for their daughters subject to the condition that the donees pay the federal and state gift taxes, aggregating $145,713, on those transfers.

B. The Commissioner erred in determining that the aforesaid transfers of 51,073 shares of stock of Owatonna Manufacturing Company, Inc. to petitioners' son and trusts for their daughters were in part sales.

C. If the Commissioner did not err in determining that the aforesaid transfers were in part sales, the Commissioner erred in determining that $64,213 in federal and state gift tax deficiencies paid in 1975 by petitioners' son and the trusts for their daughters relating to the aforesaid 1972 transfers was includable in the alleged purchase price for, or was otherwise income relating to, the transfer of the aforesaid 51,073 shares of stock.

D. If the Commissioner did not err in determining that the aforesaid transfers were in part sales, the Commissioner erred in determining that the amount realized on the aforesaid alleged partial sale by the petitioners as cash basis taxpayers exceeded $62,992 in 1972.

5. The facts upon which the petitioners rely, as the basis for their case, are as follows:

A. The petitioners are and were during the taxable year 1972 husband and wife, and they timely filed a joint

individual income tax return for 1972 on the cash basis of accounting.

B. On or about April 1, 1972, petitioners made gifts of 51,073 shares of the stock of Owatonna Manufacturing Company, Inc. to or for the benefit of their three adult children. Petitioners' son, Eugene F. Diedrich, was given 17,025 shares outright, and 17,024 shares were given in separate trusts for the benefit of each of petitioners' daughters, JoAnne D. Petkus and Madelyn D. Smith, pursuant to irrevocable trusts created on April 1, 1972 by petitioner Victor P. Diedrich. These gifts were made subject to the condition that each donee pay the federal and state gift taxes attributable to the transfers as evidenced by an agreement in the following form signed by the son and the trustee of the trusts:

> I have been informed that this gift is being made subject to my paying the gift tax (federal and state) on same. This letter can be taken as my acceptance of the proposed condition of the gift, and I agree to accept as my share of the gift taxes an amount which is commuted by your tax counsel, Haskins & Sells.

C. On or before August 15, 1972, petitioners timely filed federal gift tax returns for the quarter ended June 1972, and on said returns petitioners consented to treat these so-called "net gifts" as if made one-half by each spouse pursuant to section 2513 of the Code. The shares of said stock were valued in said gift tax returns at $7.80 per share for an aggregate value of $398,369, resulting in federal gift taxes of $62,992, all of which was paid during 1972 by the donees. On or before April 15, 1973, petitioners timely filed Minnesota gift tax returns for 1972 and reported these gifts therein, resulting in Minnesota gift taxes of $18,508, all of which was paid during 1973 by the donees.

D. Upon audit of petitioners' gift tax returns in 1975, the value of the stock was increased to $13 per share, for an aggregate value of $663,949, resulting in additional combined federal and state gift taxes of $64,213, all of which was paid in 1975 by the donees.

E. Petitioners did not report any income on their joint income tax return for 1972 on account of these gifts, or the donees' agreement to pay the gift taxes arising out of the transfers, or the actual payment by the donees of a portion of said gift taxes in 1972.

F. Upon audit of petitioners' 1972 income tax return, the Commissioner determined that petitioners realized a long-term capital gain on the ground that said gifts were partially a sale of the aforementioned stock to petitioners' son and trusts for their daughters in the amount by which the total federal and state gift taxes of $145,713 paid in 1972, 1973 and 1975 exceeded petitioners' basis of $51,073 in the shares transferred.

G. Petitioners realized no income on account of these net gifts; petitioners' detached generosity was the antithesis of an income producing transaction so that there was no sale involved in the 1972 transfers.

H. In any event, the amount received by petitioners in 1972 cannot exceed the $62,992 in gift taxes actually paid by the donees in cash in that year because the donees' unsecured promises to pay the gift taxes are not the equivalent of cash and because the obligations to pay more than said $62,992 did not arise until after 1972 in 1973 and 1975.

I. Any gift taxes paid for petitioners are gifts from their children, excludable from petitioners' income pursuant to section 102 of the Code.

J. The gift taxes paid for petitioners in 1975 as set forth in paragraph 5 D above were voluntarily paid by the donees and not pursuant to the agreement quoted in paragraph 5 B above.

WHEREFORE, the petitioners pray that the Court may hear the proceeding and:

1. Determine that the Commissioner erred as alleged in the assignment of error set forth in paragraph 4 hereinabove:

2. Find that there is no deficiency in income tax for the calendar year 1972 other than the $600 not here in dispute; and

3. Give such other and further relief as in the premises the Court may deem fit and proper.

/s/ Phillip H. Martin
612/340-2845

/s/ Nicky R. Hay
612/340-2932
2300 First National Bank Building
Minneapolis, Minnesota 55402

Of Counsel: Dorsey, Windhorst, Hannaford, Whitney & Halladay

Dated: Feb. 24, 1977

**Exhibit A**

[illegible] Revenue Service
[illegible] gional Commissioner

- 8 -

Date: NOV 30 1976

Tax Year Ended and Deficiency:
12/31/72 $27,631.00

Mr. Victor P. Diedrich and
Mrs. Frances T. Diedrich
530 Academy Street
Owatonna, Minnesota 55060

Person to Contact:
Robert J. Walsh
Contact Telephone Number:
(612) 725-5867

Dear Mr. and Mrs. Diedrich:

This letter is a NOTICE OF DEFICIENCY—as required by law—that we have determined the income tax deficiencies shown above. We regret we have been unable to reach a satisfactory agreement in your case. The enclosed statement shows how the deficiencies were computed.

If you do not intend to contest this determination in the United States Tax Court, please sign and return the enclosed waiver form. This will permit an early assessment of the deficiencies and limit the accumulation of interest. The enclosed self-addressed envelope is for your convenience.

If you decide not to sign and return the waiver, the law requires that after 90 days from the date of mailing this letter (150 days if this letter is addressed to you outside the United States) we assess and bill you for the deficiencies. However, if within the time stated you contest this determination by filing a petition with the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217, we may not assess any deficiencies and bill you until after the Tax Court has decided your case. You can obtain a copy of the rules for filing a petition by writing to the Clerk of the Tax Court at the Court's Washington, D.C., address stated above.

If you intend to file a petition with the United States Tax Court, you must do so within the time stated above (90 or 150 days, as the case may be); this period is fixed by law, and the Court cannot consider your case if your petition is filed late.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely yours,

Donald C. Alexander
Commissioner
By

James R. Wells
Chief, Appellate Office

Enclosures:
Statement
Waiver
Envelope

316 N. Robert St. St. Paul, Minn. 55101

Form L-21 AD (Rev. 11-74)

Form 4089 (Rev. November 1974) | Statutory Notice of Assessment - Waiver | AP:STP RJH:GJC:cab

(Name and Address of Taxpayer(s))

- 9 -

Victor P. Diedrich and Frances T. Diedrich
530 Academy Street
Owatonna, Minnesota 55060

| Kind of Tax | ☑ Copy to Authorized Representative |
|---|---|
| Income | Frederick W. Bassinger, Haskins & Sells<br>1950 IDS Tower, Minneapolis, Minnesota 55402 |
| Taxable Year Ended | Deficiency (Increase in Tax and Penalties) |
| December 31, 1972 | $27,831.00 |

See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

| Signature | | | |
|---|---|---|---|
| | ▶ | | Date |
| | ▶ | | Date |
| | By ▶ | Title | Date |

**Note:**

If you consent to the assessment of the amounts shown in this waiver, please sign and return the form in order to limit the accrual of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled; nor prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court.

**Who Must Sign**

If you filed jointly, both you and your spouse must sign. If the taxpayer is a corporation this waiver must be signed with the corporate name followed by the signatures and titles of the officers authorized to sign.

Your attorney or agent may sign this waiver provided his action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee), Form 56, Notice of Fiduciary Relationship, should, unless previously filed, accompany this form.

If you agree, please sign one copy and return it; keep the other copy for your records.

INDIVIDUAL INCOME TAX

| Victor P. & Frances T. Diedrich | - 10 - | 12-31-72 | |
|---|---|---|---|
| Taxable Income or Adjusted Gross Income as Shown in: ☒ Return as Filed ☐ Preliminary Letter Dated ☐ Statutory Notice Dated | | | |
| Increases (or Decreases) in Income (See attached explanation of items) | | 49,184.00 | |
| a. Dividend income | | 3,700.00 | |
| b. Other deductions | | (2,500.00) | |
| c. Capital gains | | 47,320.00 | |
| Taxable Income as Revised | | 97,704.00 | |
| Tax ALTERNATIVE TAX FROM SCHEDULE 3 | | 44,483.00 | |
| Less: Tax Credits Contributions to candidates per return | | 13.00 | |
| Subtotal | | 44,470.00 | |
| Add: Self-Employment Tax | | | |
| Tax from Recomputing Prior Year Investment Credit | | | |
| | | | |
| | | | |
| | | | |
| Tax Liability | | 44,470.00 | |
| Liability Previously Assessed Per Return | | 16,639.00 | |
| Increase (or Decrease) in Tax | | 27,831.00 | |

Tax Computation

Form 3611 (Rev. 3-74) Dispose of all prior issues. Department of the Treasury - Internal Revenue Service

EXPLANATION OF ITEMS

TAXPAYER: Victor P. & Frances T. Diedrich — - 11 - — YEAR PERIOD ENDED: 12-31-72

a. It is determined that accounting fees in the amount of $3,700.00 paid on your behalf by the Owatonna Manufacturing Company, Inc. is dividend income which you did not report on your return. Accordingly, taxable income is increased by $3,700.00.

b. It is determined that $2,500.00 of the above fees is for tax preparation and tax planning expense which is allowable as an itemized deduction. Accordingly, taxable income is decreased by $2,500.00.

c. It is determined that as a result of your gift in 1972 of 51,073 shares of stock of Owatonna Manufacturing Company, Inc., to your son and trusts for your daughters with a fair market value of $663,949, subject to the condition that the donees would pay the Federal and State gift tax, you have realized taxable income as shown below:

| | |
|---|---|
| Federal gift tax | $112,200.00 |
| Minnesota gift tax | 33,513.00 |
| Total gift tax paid | $145,713.00 |
| Less adjusted basis of stock (51,073 shares @ $1.00) | 51,073.00 |
| Realized gain | $ 94,640.00 |
| Recognized gain--50% | $ 47,320.00 |

Accordingly, taxable income is increased by $47,320.00.

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

Form 4549-C (Rev. ...-73)

# INCOME TAX AUDIT CHANGES
## COMPUTATION OF ALTERNATIVE TAX – INDIVIDUALS AND FIDUCIARIES

| NAME(S) OF TAXPAYERS | | SOCIAL SECURITY OR EMPLOYER IDENTIFICATION NUMBER |
|---|---|---|
| Victor P. & Frances T. Diedrich | - 12 - | 473-03-2601 |

| | | Year: | Year: 1972 | Year: |
|---|---|---|---|---|
| PART I | 1. CORRECTED TAXABLE INCOME (from line 6, page Schedule 1) | | 97,704 | |
| Complete for all years | 2. LESS: 50% OF EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS | | 67,355 | |
| | 3. BALANCE | | 30,349 | |
| | 4. EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS (line 2 multiplied by 2) | | 134,710 | |
| | 5. TAX ON AMOUNT ON LINE 3 | | 8,016 | |
| | 6. a. FOR 1969 AND PRIOR YEARS – 25% OF LINE 4<br>b. FOR 1970 AND SUBSEQUENT YEARS, IF LINE 4 NOT OVER $50,000* – 25% OF LINE 4<br>c. FOR 1970 AND SUBSEQUENT YEARS, IF LINE 4 EXCEEDS $50,000* – AMOUNT FROM LINE 18 FOR 1970 AND 1971 AND AMOUNT FROM LINE 19 FOR LATER YEARS | | 36,467 | |
| | 7. ALTERNATIVE TAX (add lines 5 and 6) | | 44,483 | |
| PART II<br>Complete only for 1970 and subsequent years when line 4 above exceeds $50,000* (for 1970 and 1971, also complete part III) | 8. AMOUNT FROM LINE 4 ABOVE | | 134,710 | |
| | 9. LONG-TERM CAPITAL GAINS (section 1201(d)(3)(C))** | | 50,000 | |
| | 10. 25% OF THE LESSER OF LINE 8 OR LINE 9 | | 12,500 | |
| | 11. TAX ON LARGER OF LINE 1 OR LINE 7 | | 43,802 | |
| | 12. TAX AT ORDINARY RATE ON SUM OF LINE 3 PLUS ½ OF LINE 9 | | 19,835 | |
| | 13. LINE 11 LESS LINE 12 (if less than zero, enter zero) | | 23,967 | |
| | 14. ADD LINES 10 AND 13 (see line 19 below) | | 36,467 | |
| PART III<br>Complete for years 1970 and 1971 if line 4 above exceeds $50,000* | 15. a. FOR 1970 – 25½% OF LINE 8 LESS LINE 9<br>b. FOR 1971 – 32½% OF LINE 8 LESS LINE 9<br>(if less than zero, enter zero) | | | |
| | 16. AMOUNT FROM LINE 10 ABOVE | | | |
| | 17. ADD LINES 15 AND 16 | | | |
| | 18. LESSER OF AMOUNTS ON LINES 14 OR 17 (enter on line 6(c) above) | | | |

* $25,000 if married filing separately.

** Long-term capital gains from (1) certain binding contracts, distributions and redemptions rates, and (2) other sources limited to the excess of $50,000 ($25,000 married filing separately) over the gains from the binding contracts, etc.

(Caption Omitted)

**STIPULATION OF FACTS (Docket No. 1800-77)**

(Filed May 22, 1978)

It is hereby stipulated and agreed that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part thereof; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The petitioners, Victor P. and Frances T. Diedrich, are husband and wife, with legal residence at 530 Academy Street, Owatonna, Minnesota 55060, which was also their legal residence at the time their petition herein was filed.

2. Petitioners timely filed a joint federal individual income tax return for the year 1972, a copy of which is attached hereto as Exhibit 1-A, with the Office of the Internal Revenue Service at Ogden, Utah.

3. Petitioners determined their income and expenses for 1972 on the cash receipts and disbursements method of accounting.

4. On April 1, 1972, Victor P. Diedrich made a gift of 51,013 shares of voting and nonvoting common stock of Owatonna Manufacturing Company, Inc. (OMC) to or for the benefit of his three adult children, Eugene F. Diedrich, JoAnne D. Petkus, and Madelyn D. Smith. Also, on April 1, 1972, Frances T. Diedrich made a gift of 60 shares of common stock of OMC to her son, Eugene F. Diedrich. A total of 17,025 shares, 12,903 shares of voting common stock and 4,122 shares of nonvoting common stock, was given outright to Eugene F. Diedrich. A total of 17,024 shares of

nonvoting common stock was given to an irrevocable trust created by Victor P. Diedrich for the benefit of his daughter, JoAnne D. Petkus, Trust Under Agreement dated April 1, 1972 (hereafter the "Petkus Trust.") A total of 17,024 shares of nonvoting common stock was given to an irrevocable trust by Victor P. Diedrich for the benefit of his daughter, Madelyn D. Smith, Trust Under Agreement dated April 1, 1972 (hereafter the "Smith Trust.") Eugene F. Diedrich was and is the sole trustee for the Petkus Trust and the Smith Trust. Eugene F. Diedrich and the Petkus Trust and the Smith Trust are hereinafter referred to as the "Donees."

5. At the time of the making of the gifts referred to in paragraph 4, above, Eugene F. Diedrich for himself and as the trustee of the Petkus Trust and Smith Trust signed three agreements on behalf of each of the Donees in the form attached hereto as Exhibit 2-B.

6. On or before August 15, 1972, petitioners timely filed federal gift tax returns for the quarter ended June 1972, copies of which are attached as Exhibits 3-C and 4-D.

7. On or before April 15, 1973, petitioners timely filed a Minnesota gift tax return for the year 1972 and reported the gifts referred to in paragraph 4 above. Minnesota gift taxes of $18,508 based on a gift of $316,869, were paid during 1973 by the Donees.

8. Upon audit of petitioners' federal gift tax returns in 1974, the value of the OMC stock given to the Donees as described in paragraph 4. above was increased from $7.80 to $13.00 per share. Thus, the value of the 51,073 shares was $663,949. To compute the gift tax liability after audit, the amount of $663,949 was reduced by the federal and state gift taxes paid or to be paid by the Donees in the amount of $145,713, and the amount of the gift was determined to

be $518,236. The additional federal and Minnesota gift taxes resulting from the audit of $64,213 were paid during 1975 by Donees.

9. On or about August 15, 1972, Eugene F. Diedrich acting in his individual capacity and as the trustee of the Petkus Trust and the Smith Trust, borrowed the sum of $62,992 from OMC. Each loan was represented by three separate checks in the aggregate amount of $62,992, payable to the order of the respective borrower. The federal gift tax liability of $62,992 shown on Exhibits 3-C and 4-D was paid on or about August 15, 1972, by Eugene F. Diedrich, individually and as trustee of the trusts, by endorsing said checks payable to the order of the Internal Revenue Service.

10. In December, 1972, the Petkus Trust and the Smith Trust each sold 2,728 shares of OMC stock to OMC at the price of $7.80 per share. The proceeds from these sales were used by the trusts to repay the loans from OMC, plus interest thereon which had accrued to the date of repayment. Eugene F. Diedrich repaid his loan from OMC, plus interest, with his personal funds.

11. On or before April 15, 1973, the Petkus Trust and the Smith Trust each sold additional shares of OMC stock to OMC at the price of $7.80 per share, and the proceeds of the sales received by the trusts were used by each trust to pay its respective computed share of the Minnesota gift taxes shown due on the petitioners' Minnesota gift tax returns filed on or about April 15, 1973. Eugene F. Diedrich used his personal funds to pay his computed share of the Minnesota gift tax liability in 1973.

12. After the audit of petitioners' gift tax returns as described in paragraph 8. above, OMC agreed to pay to the

Petkus Trust and the Smith Trust additional consideration for the purchase of the OMC stock in December, 1972, from the trusts as described in paragraph 10. herein to bring the purchase price up to $13 per share, plus interest thereon from the date of sale to the date of payment of such additional consideration. Each trust used these proceeds to pay its respective computed shares of the additional federal and Minnesota gift taxes resulting from the audit. Eugene F. Diedrich paid his computed share of the additional gift taxes from his personal funds.

13. Petitioners had a basis of $1.00 per share in the OMC stock given to the Donees as described in paragraph 4. above, and as of the date of the gift, had held this OMC stock longer than six months.

14. One of the reasons petitioners made the gift to their son, Eugene F. Diedrich, who is now President of OMC, was to encourage his continued participation in the business. One of the reasons petitioners made the gift of stock in OMC in trust for the benefit of their daughters was to provide them with an equity interest in the family business. Eugene F. Diedrich, petitioners' son, is the sole trustee of the trusts created for the benefit of the Diedrichs' daughters to ensure that majority control of the outstanding shares of stock of all types in OMC will remain in the control of the Diedrich family.

15. Respondent concedes that the gift taxes paid by the Donees in 1973 and 1975 should not be considered in computing the gain respondent alleges the petitioners realized in 1972 as a result of the gifts referred to in paragraph 4 above. Thus, respondent now contends the gain should be computed as follows:

| | |
|---|---|
| Amount realized (gift tax liability paid by Donees) | $62,992.00 |
| Less: adjusted basis in stock transferred (see paragraph 13 above) | 51,073.00 |
| Long-term capital gain | $ 1,919.00 |
| Less: Section 1202 deduction | 959.50 |
| Gain recognized | $ 959.50 |

16. Petitioners concede the correctness of respondent's adjustments in the statutory notice increasing taxable income $3,700.00 for dividend income and decreasing taxable income $2,500.00 for other deductions in 1972.

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By: (Signed) Donald W. Wolf
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Tel. No. 612-725-7474

May 18, 1978

(Caption Omitted)

**MEMORANDUM FINDINGS OF FACT AND OPINION (Docket No. 1800-77)**

(Filed November 6, 1979)

[The Memorandum Findings of Fact and Opinion of the Tax Court in this case is reproduced at pages A17 through A22 of the Appendix to the Petition for a Writ of Certiorari in this case.]

(Caption Omitted)

**DECISION (Docket No. 1800-77)**

(Filed November 13, 1979)

Pursuant to the opinion of the Court filed November 6, 1979, and amended by Court Order dated December 17, 1979, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1972 in the amount of $600.00.

Judge.

Entered:

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Tel. No. 612-725-7474

Date February 7, 1980

(Caption Omitted)

**NOTICE OF APPEAL (Docket No. 1800-77)**

(Filed May 12, 1980)

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Eighth-Circuit from the decision of this Court entered in the above-captioned proceeding of the 13th day of February, 1980.

Petitioners resided in Owatonna, Minnesota at the time they filed their petition with the Tax Court. Accordingly, venue is properly placed with the United States Court of Appeals for the Eighth Circuit.

(Signed) M. Carr Ferguson
Assistant Attorney General
Department of Justice
(Signed) N. Jerold Cohen
Chief Counsel
Internal Revenue Service

Dated: May 5, 1980

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 80-1376

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
*Appellees,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Appellant.*

Appeal From the United States Tax Court

---

No. 80-1421

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED,
*Appellee,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Appellant.*

Appeal From the United States Tax Court

**OPINION**

[The Opinion of the Eighth Circuit in these cases is reproduced at pages A1 through All of the Appendix to the Petition for a Writ of Certiorari in this case.]

(Caption Omitted)

**JUDGMENT (No. 80-1376)**

[The Judgment of the Eighth Circuit in this case is reproduced at page A23 of the Appendix to the Petition for a Writ of Certiorari in this case.]

(Caption Omitted)

**JUDGMENT (No. 80-1421)**

[The Judgment of the Eighth Circuit in this case is reproduced at page A24 of the Appendix to the Petition for a Writ of Certiorari in this case.]

(Caption Omitted)

**ORDER DENYING REHEARING EN BANC**

**(No. 80-1421)**

[The Order Denying Rehearing *En Banc* in this case is reproduced at page A25 of the Appendix to the Petition for a Writ of Certiorari in this case.]

**ORDER DENYING REHEARING EN BANC**

**(No. 80-1376)**

(Caption Omitted)

[The Order Denying Rehearing En Banc in this case is reproduced at page A26 of the Appendix to the Petition for a Writ of Certiorari in this case.]

Office-Supreme Court, U.S.
FILED
AUG 24 1981
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CLERK

No. 80-2204

# In the Supreme Court of the United States

OCTOBER TERM, 1980

---

VICTOR P. DIEDRICH AND
FRANCES T. DIEDRICH, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

---

## MEMORANDUM FOR THE RESPONDENT

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REX E. LEE
*Solicitor General*
*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

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# In the Supreme Court of the United States

OCTOBER TERM, 1980

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No. 80-2204

VICTOR P. DIEDRICH AND
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UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

---

## MEMORANDUM FOR THE RESPONDENT

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The question presented by the petitions in these federal income tax cases is whether, as a result of petitioners'[1] transfers of appreciated property subject to the condition that the donees pay the resulting federal and state gift taxes,

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[1]As used in this Memorandum, the term "petitioner" refers to the decedent rather than the executor in *United Missouri Bank*, when the context so indicates.

they realized income (taxable as capital gain) to the extent the gift taxes the donees paid exceeded petitioners' bases in the transferred property.

In both of these cases, petitioners made a gift of low basis, highly appreciated securities to a member of their family.[2] As a condition of the gift, the donees agreed to pay the donors' federal and state gift taxes incurred as a result of the gift. The gift taxes paid by the donees in each instance exceeded petitioners' bases in the securities transferred (Pet. App. A3).

On audit, the Commissioner determined that petitioners realized taxable gain on the transfers to the extent that the gift taxes paid exceeded petitioners' adjusted bases in the property transferred. The Tax Court, however, rejected the Commissioner's analysis. Following *Turner* v. *Commissioner*, 410 F. 2d 752 (6th Cir. 1969), aff'g per curiam 49 T.C. 356 (1968), and *Hirst* v. *Commissioner*, 572 F. 2d 427 (4th Cir. 1978) (en banc), the Tax Court held that the donor of property in such a case does not realize taxable income on the donee's payment of the gift tax (Pet. App. A12-A22). See *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.).

The court of appeals reversed (Pet. App. A1-A11). It concluded that *Turner* and *Hirst* were incorrectly decided and that "to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the property transferred, the donors realized taxable income" (Pet. App.

---

[2]Petitioners' basis in the stock transferred in *Diedrich* was $51,073. The fair market value of the securities, as reported in their 1972 return, was $398,369 (Pet. App. A18-A20). In *United Missouri Bank*, the decedent's basis in the 90,000 shares of stock transferred to her son was $8,742.60 (Pet. App. A14-A15). Although the Tax Court did not determine the fair market value of this stock at the time of the gift, the substantial gift tax paid in 1971 ($232,630.09) indicates that the stock's value exceeded $1,000,000. See 26 U.S.C. (1970 ed.) 2502.

A11). In so holding, the court of appeals cited with approval *Johnson* v. *Commissioner*, 495 F. 2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F. 2d 12 (2d Cir. 1980), in which donors of property encumbered by nonrecourse indebtedness were held taxable on the transfers to the extent the indebtedness exceeded their bases in the property. As the court stated, "[i]t makes no difference whether he [the donor] receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit" (Pet. App. A10).

## DISCUSSION

1. Section 61(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that gross income means all income from whatever source derived. Section 1001(a) of the Code provides in particular that the gain from a sale or other disposition of property is the excess of the amount realized therefrom over the transferor's adjusted basis in the property. The amount realized is defined in Section 1001(b) of the Code as the sum of any money received plus the fair market value of any other property received.

It is well established that the amount realized under Section 1001 does not mean that the taxpayer must receive cash (or property) in hand. Rather, the concept of amount realized encompasses a measurable economic benefit in any of many forms, including a discharge of personal liability. Thus, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), this Court held that payment of a taxpayer's federal income tax liability by another person is tantamount to actual payment of that amount to the taxpayer and use by him of that money to pay his taxes. Similarly, the discharge of indebtedness on the transfer of property constitutes the receipt of income for purposes of Section 61(a). *Crane* v. *Commissioner*, 331 U.S. 1, 13-14 (1947).

In accordance with these principles, the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. By making the gifts conditional on the donees' payment of the applicable gift taxes, petitioners have received a real and substantial economic benefit, because the donee's payment discharged petitioners from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. As the court below observed (Pet. App. A10), the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. From an economic standpoint, a net gift transfer is equivalent to the donor's sale of a portion of his property for cash in an amount equal to the gift tax liabilities, and thereafter donating the remainder of the property to the intended recipients. Since the donor would clearly be liable for the payment of income tax in that case, assuming the amount realized by the sale exceeded his basis (cf. Treasury Regulations on Income Tax, Section 1.1001-1(c) (26 C.F.R.)),[3] there is no reason for excusing him from income tax on a net gift transfer merely because a different route leading to the same destination is followed. As this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

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[3]Although this type of transaction has been referred to as a "part gift, part sale" (see, *e.g.*, *Turner* v. *Commissioner*, *supra*), that descriptive phrase lacks substantive content. It is used merely to illustrate situations in which the transferor has disposed of property (by gift, sale, or some other means) for a consideration less than its fair market value. But cf. *Evangelista* v. *Commissioner*, 629 F. 2d 1218, 1221 (7th Cir. 1980).

Thus, in *Johnson* v. *Commissioner, supra,* the court imposed an income tax upon the donor of low basis, highly appreciated stock where, immediately prior to the gift, the donor had pledged the stock as collateral for a loan, the proceeds of which were used in large part to satisfy the donor's gift tax liability on the transfer. Describing the interrelated series of transactions there as equivalent to the donee's payment of the donor's gift tax liability, the court of appeals stated that "[t]he payment of a donor's gift tax liability by the donee constitutes income to the donor" (495 F. 2d at 1083). The Second Circuit reached a similar conclusion in *Estate of Levine* v. *Commissioner, supra,* where the donor of property encumbered by nonrecourse mortgages in excess of his adjusted basis was held taxable on that excess. Expressing agreement with the decision in *Johnson,* which it viewed as effectively overruling *Turner* as a precedent (634 F. 2d at 17), the court in *Levine* declined to follow *Hirst* and stated that "the assumption of another's legal obligation or debt is considered income" (*id.* at 16).

2. While we believe that the court of appeals correctly held that a donor in a net gift situation realizes taxable income to the extent that the amount of gift taxes paid by the donee exceeds the donor's adjusted basis in the property transferred, we agree with petitioner (Pet. 8-12) that the decision below conflicts with that of the Fourth Circuit in *Hirst* v. *Commissioner, supra,* and with those of the Sixth Circuit in *Turner* v. *Commissioner, supra,* and *Owen* v. *Commissioner,* 81-2 U.S.T.C. para. 9509 (June 23, 1981), petition for rehearing with suggestion of rehearing en banc pending, No. 78-1341 (6th Cir.). [4] The Internal Revenue

---

[4] In *Owen,* a divided panel of the court of appeals held that it would follow *Turner* in a net gift situation on stare decisis grounds. Although two members of the panel regarded *Turner* as incorrectly decided, the court was unwilling to depart from the rule of law announced in *Turner*

Service advises that there are at least 22 other cases involving approximately $4.5 million in income taxes pending administratively or in the lower courts, and presenting the same issue under consideration here.[5] Accordingly, we do not oppose the granting of the petition for a writ of certiorari.

## CONCLUSION

The petition for a writ of certiorari should be granted.

REX E. LEE
*Solicitor General*

AUGUST 1981

---

unless that case was overruled by the full court of appeals or unless this Court held to the contrary.

In *Evangelista* v. *Commissioner, supra,* 629 F. 2d at 1222-1224, the court of appeals analyzed, but expressly declined to decide (compare Pet. 9), the issue whether a net gift can result in income to the donor. The position of the Fifth Circuit on this issue is unclear. Compare *Estate of Davis* v. *Commissioner,* 469 F. 2d 694 (5th Cir. 1972), aff'g per curiam 30 T.C.M. 1363 (1971), with *Malone* v. *United States,* 455 F. 2d 502 (5th Cir. 1972), aff'g per curiam 326 F. Supp. 106 (N.D. Miss. 1971).

[5]There are nine such cases pending in the courts of appeals: *Owen* v. *Commissioner, supra; Estate of Henry* v. *Commissioner, supra; Benson* v. *Commissioner,* 37 T.C.M. 989 (1978), appeal pending, No. 79-1032 (6th Cir.); *Bradford* v. *Commissioner,* 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Davis* v. *Commissioner,* 74 T.C. 881 (1980), appeal pending, No. 81-1187 (6th Cir.); *Estate of Currey* v. *Commissioner,* 41 T.C.M. 800 (1981), appeal pending, No. 81-1423 (6th Cir.); *Estate of Warren* v. *United States,* 47 A.F.T.R.2d 1457 (Mar. 24, 1981), appeal pending, No. 81-1462 (8th Cir.); *Estate of Weeden* v. *Commissioner,* 39 T.C.M. 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *McNiece* v. *Commissioner,* 41 T.C.M. 969 (1981), appeal pending, No. 81-7341 (9th Cir.).

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No. 80-2204

# In the Supreme Court of the United States

**October Term, 1981**

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent,*

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D.
GRANT, DECEASED, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF FOR PETITIONERS

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## QUESTION PRESENTED

Does the donor of appreciated property, given on condition that the donee agree to pay the resulting gift taxes, realize taxable income upon the donee's payment of the gift taxes?

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# No. 80-2204

# In the Supreme Court of the United States

**October Term, 1981**

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UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
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COMMISSIONER OF INTERNAL REVENUE,
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ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF FOR PETITIONERS

## OPINIONS BELOW

The opinion of the Court below is reported as *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). That opinion reversed decisions of the United States Tax Court reported as *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979) and *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980) which had been consolidated in the Court of Appeals for argument and disposition. For convenience, these cases will be referred to as *Diedrich* and *Grant*.

## JURISDICTION

The opinion of the United States Court of Appeals for the Eighth Circuit was filed March 4, 1981, and judgment was entered on that day. On March 13, 1981, and March 17, 1981, petitions for rehearing en banc were filed respectively by counsel for *Diedrich* and *Grant*. These petitions were denied by the Court of Appeals on March 27, 1981. Copies of the orders of the Court of Appeals denying the petitions for rehearing are included as Appendix E to the Petition for a Writ of Certiorari at pages A25 and A26. Jurisdiction by writ of certiorari is vested in the United States Supreme Court by 28 U.S.C. §1254 (1976). The Petition for a Writ of Certiorari was filed on June 25, 1981, and the Writ granted by this Court on October 5, 1981.

## STATEMENT OF THE CASE

Two separate cases are before the Court on a joint Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit. Both cases were appealed to the Eighth Circuit by the Commissioner of Internal Revenue from adverse decisions by the United States Tax Court. The cases were consolidated in the Eighth Circuit for oral argument and decision. The relevant facts are undisputed and there are no material factual distinctions between the two cases. Accordingly, the factual situation will be described by reference to the *Grant* case.[1]

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1. In the *Diedrich* case, some of the gifts were made to trusts while both gifts in *Grant* were to an individual donee. No trust income was used to pay the gift taxes and this factual difference has not been urged as a basis for a different disposition of the cases.

In 1970, in reliance on existing law, Frances D. Grant gave 50,000 voting trust certificates, representing underlying common stock of BMA Corporation, to her son subject to his express agreement to pay the resulting gift taxes. (App. 5 & 15.) In January, 1971, Mrs. Grant gave an additional 40,000 voting trust certificates to her son subject to the same condition. (App. 5, 16.) The gift taxes on both transfers were due in the spring of 1971 and these taxes, totalling $232,630, were paid by Mrs. Grant's son. (App. 5, 6, 15, 16.)

Mrs. Grant did not report any income in connection with the net gifts in either her 1970 or 1971 federal income tax returns. Upon audit, the Commissioner determined that Mrs. Grant's gifts were, in part, sales of the property to her son, resulting in long-term capital gains,[2] measured by the difference between the gift taxes paid by Mrs. Grant's son and her basis in the voting trust certificates, computed as follows (App. 18, 19):

| | |
|---|---|
| Gift taxes paid | $232,630.09 |
| Less: Basis in securities transferred | 8,742.60 |
| Long-term capital gain | 223,887.49 |
| 50% deduction for capital gain | 111,943.74 |
| Increase in taxable income | $111,943.75 |

Mrs. Grant filed a petition for redetermination of the proposed deficiencies in the United States Tax Court. In

2. Capital gains are gains from the sale or exchange of property. Section 1222, I.R.C. 1954. The amount of the gain is the difference between the amount of the money and other property received less the taxpayers' adjusted basis in the property. §1001, I.R.C. 1954. The "adjusted basis" is basis less certain adjustments, generally cost less depreciation. §§1011, 1012, 1016, I.R.C. 1954. The basis for property received by gift is the same as in the hands of the donor, increased by adjustments for the gift taxes paid. §1015, I.R.C. 1954.

a Memorandum Opinion filed February 27, 1980, Mrs. Grant's motion for judgment on the pleadings was sustained and the proposed deficiencies were set aside. (Appendix B to Petition for a Writ of Certiorari.) The Tax Court's opinion in favor of the taxpayer in *Diedrich* was filed on February 13, 1980. (Appendix C to Petition for a Writ of Certiorari.) On March 4, 1981, a three-judge panel of the Court of Appeals reversed the Tax Court's decision in each case and entered judgment in favor of the Commissioner. *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). (Appendix A to Petition for a Writ of Certiorari.)

## SUMMARY OF ARGUMENT

The decision of the Eighth Circuit in this case is based upon its finding that petitioners realized a substantial economic benefit upon payment of the gift taxes by the donees of the petitioners' net gifts. The net gift, however, produces no economic benefit to the donor. The amount of the gift tax on a net gift is exactly the same as the amount of the gift tax on an ordinary gift of the net amount where the donor makes payment of the gift tax. The diminution in the donor's estate in both instances is the same. A donor does not profit economically from any gift. He has an economic loss and that economic loss is not reduced by use of a net gift.

The first decision dealing directly with the income tax consequences to the donor of a net gift was *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969). In that case, net gifts were made to trust donees and to individual donees. The Commissioner conceded that a part sale had not occurred with respect to the trust donees and the Court found that a part sale had not taken place to the individual

donees. The Sixth Circuit affirmed. Subsequent to that decision, the Tax Court has ruled in ten separate cases that the donor of a net gift does not realize taxable gain from the disposition of property in a net gift. The Courts of Appeals for the Fourth, Fifth, and Sixth Circuits have affirmed three of those decisions. The Eighth Circuit decision in this case is the sole judicial decision in favor of the government in the net gift cases.

None of the cases relied upon by the Eighth Circuit in reaching its decision involves a net gift. In each instance, a taxable transaction was found to have taken place. The Eighth Circuit placed primary reliance upon this Court's decision in *Crane v. Commissioner*, 331 U.S. 1 (1947), which did not involve any issue as to taxability of the transaction involved, a sale, but rather involved determination of the amount realized by the taxpayer from the sale. The Eighth Circuit also relied on this Court's decision in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), involving the payment of a corporate officer's income taxes by his employer. Those payments were made as additional compensation for his services and were found to constitute additional taxable income to him. Again, a traditional taxable transaction was involved, *i.e.* the payment of compensation for personal services.

The net gift cases are directly in point. The cases relied upon by the Eighth Circuit are not directly in point and they are inapposite to the Eighth Circuit's decision. In each case involving the conveyance of property subject to an encumbrance, the taxable transaction or event has been the conveyance. The Eighth Circuit did not find the gift transfers here to be taxable and cases finding the transfer of property subject to encumbrances taxable do not support the Eighth Circuit's decision. The net gift cases were correctly decided and should be followed.

The economic benefit found by the Eighth Circuit to exist in the net gift cases is the discharge of the donor's gift tax liability by the donee. In the net gift, the donor places at the disposal of the donee properties sufficient to pay the gift taxes and secures from the donee an agreement to make the required payment. The donee is a conduit of the donor in making the tax payment and in doing so he is acting for the account of the donor. Legally and economically, the donor has paid the gift taxes. It is of no economic benefit to him that tender of payment is made by the donee and there is no economic loss to the United States Treasury in receiving the tax payment from the donee.

The net gift decision in *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), was made by the Tax Court in 1968. The decision has been followed uniformly by the Tax Court and also by the Courts of Appeals until the decision of the Eighth Circuit in this case twelve years later. The Tax Court has special competence in dealing with tax matters, and its ruling on the law in *Turner* and in this case is supported by reason and precedent and should be followed.

The decision in *Turner* was substantially influenced by the position taken by the Commissioner in earlier gift cases involving the transfer of property into trusts. In those cases, the Commissioner asserted there had been no part gift, part sale, but rather the retention of an income interest in the trust. Under these circumstances, fair play and uniform administration of the tax laws will be served by a decision of this Court following the net gift decisions and rejecting the theory advanced by the Eighth Circuit. The matter has gone too far, too long, to begin anew.

Additionally, in the 1976 Tax Reform Act Congress focused on the possible tax loss when low basis, highly ap-

preciated property is given to low basis taxpayers and enacted section 644 of the Internal Revenue Code. Section 644 places limitations on "bracket advantage," but it does not affect net gifts. In light of the decision in *Turner*, the failure of Congress to expressly include net gifts in section 644 indicates it did not believe a tax on net gift transfers is appropriate.

However, even if this Court feels compelled to affirm the decision of the Eighth Circuit, the same considerations discussed above support a determination by this Court to make its decision prospective only. The petitioners in this case and the other taxpayers awaiting the outcome of this case should not be penalized for structuring their tax planning in accordance with the decision of the Tax Court in *Turner*, as affirmed by the Sixth Circuit, and from which no petition for a writ of certiorari was filed with this Court.

## ARGUMENT

### A. Question Presented.

The question presented in this case is whether or not the donor of appreciated property, given on condition that the donee pay the resulting gift taxes, realizes taxable income upon the donee's payment of the gift taxes. The term "net gift," as used in this brief, refers solely to this specific transaction. It does not refer to a transfer of property subject to an indebtedness, to a transfer of property in exchange for a transfer of money to the donor, or to any other transfer. The only transaction which this Court is asked to examine is one in which the donee's sole obligation is payment of gift taxes to the Treasury.

The Commissioner's theory of taxation is that payment of the gift taxes by the donee is a real and substantial economic benefit to the donor which is taxable as income under

section 61 of the Internal Revenue Code. Section 61 defines gross income generally as income from whatever source derived, including gains from dealings in property. The Commissioner further theorizes that the donor's income arises from the sale or other disposition of property and the amount, determined under section 1001, I.R.C. 1954, is equal to the difference between the gift taxes paid and the donor's adjusted basis in the property. The taxpayers claim that a gift was made—nothing more, nothing less. A gift of appreciated property under these circumstances does not result in income to the donor. *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964).

**B. Economics of a Net Gift.**

There are only two factual situations in which a net gift will result in tax savings to a family unit. First, if it is necessary to sell some portion of the property to pay gift taxes and the donee is in a lower tax bracket than the donor. Second, if the donor and the donee want to avoid selling any of the property and a sale would be necessary if the gift taxes are paid by the donor, but not if they are paid by the donee who has or can arrange for the necessary funds. A net gift in this situation will permit the family unit to defer recognizing gain on the property until it is sold or exchanged by the donee in a taxable transaction.

For gift tax purposes, the gift tax is imposed on the net amount received by the donee. This is the difference between the total value of the property transferred and the amount of the gift taxes. Rev. Rul. 75-72, 1975-1 C.B. 310. For example, if a net gift of $1,000 is made by a donor in a 25% bracket, the gift portion, represented by "X" in this example, would be as follows:

$$\begin{aligned} X + .25X &= \$1{,}000 \\ 1.25X &= \$1{,}000 \\ X &= \$\ 800 \end{aligned}$$

The donor has made an $800 gift for gift tax purposes and the gift tax is $200 (.25 x $800). In this example, the $1,000 net gift produces the same gift tax as an $800 gift where the taxes are paid by the donor. The donor, the donee, and the U. S. Treasury are all in the same economic position.

The following examples compare ordinary gifts and net gifts under various circumstances. In the examples, the donor owns stock having a value of $1.00 per share. The donor has a zero basis in this stock, for capital gains purposes, and he is in a 25% gift tax bracket. Capital gains are taxed at an effective rate of 25% for the donor and at 10% for the donee.

In Example I, neither the donor nor the donee is required to sell stock to pay the gift taxes.

EXAMPLE I

| | Donor's Estate | | Donee's Estate | |
|---|---|---|---|---|
| | Stock | Cash | Stock | Cash |
| A. *Ordinary Gift* | | | | |
| Before Gift | 1,000 Shares | $ 200 | | $ 200 |
| Gift | (800) | | 800 Shares | |
| Gift Tax | | (200) | | |
| After Gift | 200 Shares | $ — | 800 Shares | $ 200 |
| Total Estate | $ 200 | | $1,000 | |
| B. *Net Gift* | | | | |
| Before Gift | 1,000 Shares | $ 200 | | $ 200 |
| Gift | (1,000) | | 1,000 Shares | |
| Gift Tax | | | | (200) |
| After Gift | — Shares | $ 200 | 1,000 Shares | $ — |
| Total Estate | $ 200 | | $1,000 | |

In Example I, the economics to the donor, to the donee and to the U.S. Treasury are the same. The only difference is the makeup of the two estates after the gift. The reasons for the net gift, in this example, are to preserve cash in the donor's estate and to confer upon the donee the benefits of owning the stock, *i.e.* dividends, future appreciation and right to vote. This is basically the *Grant* case. There are no tax avoidance motives. ***The donor receives no economic benefit as a result of the donee's payment of the gift taxes.***

The following example shows the result of a net gift when the donor lacks sufficient cash to pay the gift taxes and is required to sell stock if an ordinary gift is made.

EXAMPLE II

| | Donor's Estate | | Donee's Estate | |
|---|---|---|---|---|
| | Stock | Cash | Stock | Cash |
| A. *Ordinary Gift* | | | | |
| Before Gift | 1,000 Shares | — | — | $ 200 |
| Sale | (250) | $250 | | |
| Gains Tax | | (63) | | |
| Gift | (750) | | 750 Shares | |
| Gift Tax | | (187) | | |
| After Gift | — Shares | | 750 Shares | $ 200 |
| Total Estate | — | | $ 950 | |
| B. *Net Gift* | | | | |
| Before Gift | 1,000 Shares | — | | $ 200 |
| Gift | (1,000) | | 1,000 Shares | |
| Gift Tax | | | | (200) |
| After Gift | — Shares | — | 1,000 Shares | — |
| Total Estate | — | | $1,000 | |

The economics to the donee and to the Treasury in Example II are different. The ordinary gift has resulted in a capital gains tax being paid the Treasury and a corresponding reduction in the amount received by the donee. *Still the donor receives no economic benefit as a result of the donee's payment of the gift taxes.*

In the final example, neither the donor nor the donee has sufficient cash to pay the gift taxes.

EXAMPLE III

| | Donor's Estate | | Donee's Estate | |
|---|---|---|---|---|
| | Stock | Cash | Stock | Cash |
| A. *Ordinary Gift* | | | | |
| Before Gift | 1,000 Shares | $ — | — | — |
| Sale | (250) | 250 | | |
| Gains Tax | | (63) | | |
| Gift | (750) | — | 750 Shares | |
| Gift Tax | | (187) | | |
| After Gift | — Shares | — | 750 shares | — |
| Total Estate | — | | $750 | |
| B. *Net Gift* | | | | |
| Before Gift | 1,000 Shares | — | — | — |
| Gift | (1,000) | | 1,000 Shares | |
| Sale | | | (222) | 222 |
| Gains Tax | | | | (22) |
| Gift Tax | | | | (200) |
| After Gift | — Shares | — | 782 Shares | — |
| Total Estate | — | | $778 | |

In Example III, some of the stock has to be sold in any event to pay the gift taxes and the total taxes are higher if the sale is made by the donor. This is basically the *Diedrich* case. If the donor and the donee were in the same tax brackets for capital gains, the total taxes would have been the same. As in Examples I and II, *the donor receives no economic benefit as a result of the donee's payment of the gift taxes.*

As shown in these examples, the net gift does not result in any economic benefit to the donor. The economic reality is that the donor can afford to reduce his estate by a certain amount—whether it be in the form of gift property, gift taxes, or capital gains taxes. Where the donor is taxed at capital gains rates higher than those of the donee and some of the property has to be sold, the net gift will produce a lower capital gains tax. The person who benefits is the donee. In any event, the donor has not profited. Economically, he is neither better off nor worse off. The net gift simply helps maximize the amount retained by the donee.

The Commissioner's "substantial economic benefit" theory was considered and rejected by the Fourth Circuit in *Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), as follows: "Before the present transaction, Mrs. Hirst owed nothing and by virtue of the transaction she received nothing. She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off." *Id.* at 431. That analysis is equally applicable to the taxpayers here, and the benefit theory should be rejected here.

### C. The Eighth Circuit Decision in This Case.

The Eighth Circuit's decision in this case is based upon its conclusion that a "benefit" inured to the donor upon payment of the gift tax liabilities by the donees.

> We agree with District Judge Thomsen's dissent in *Hirst*, joined by two members of the en banc court, that when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income. Here, as in *Hirst*, "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities."

643 F.2d at 504 (footnote omitted). The Eighth Circuit believed that *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), had been incorrectly decided and that the correct approach was that taken in *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner*, 634 F.2d 12 (2nd Cir. 1980).

**D. Previous Net Gift Decisions.**

The Commissioner's position had been rejected in every net gift case in which it was litigated prior to the Eighth Circuit decision in this case.[3] *See McNeice v. Commissioner*, 41 T.C.M. (CCH) 969 (1981); *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), *rev'd*, 643 F. 2d 499 (8th Cir. 1981); *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), *rev'd*, 643 F.2d 499 (8th Cir. 1981); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979), *appeal docketed*, No. 80-7127 (9th Cir.); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978), *appeal docketed*, No. 79-1032 (6th Cir.); *Bradford v. Commissioner*, 70 T.C. 584 (1978), *appeal docketed*, No. 79-1094 (6th Cir.); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978),

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3. On March 24, 1981, the United States District Court for the Northern District of Iowa found for the Commissioner in a net gift case on the basis of *Diedrich*. *Molinaro v. United States*, No. 79-2040 (D. Iowa, filed March 24, 1981) [81-1 U.S.T.C. (CCH) ¶9362].

*appeal docketed*, No. 78-1340 (6th Cir.); *Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978), *aff'd*, 652 F.2d 1271 (6th Cir. 1981); *Hirst v. Commissioner*, 63 T.C. 307 (1974), *aff'd*, 572 F.2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); *Krause v. Commissioner*, 56 T.C. 1242 (1971), *appeal dismissed* (6th Cir. 1972); *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969).

*Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), is the leading case. In *Turner*, gifts of corporate stock were made to various individuals and trusts subject to the donees agreeing to pay the resulting gift taxes. The funds for paying the taxes were raised by the donees in a variety of ways. The Commissioner asserted an income tax deficiency against the donor on the theory that each transfer was a part sale, part gift. The Tax Court rejected the Commissioner's theory, concluding that the transfers were gifts only and did not result in any taxable gain to the donor. The decision was affirmed, *per curiam*, by the Court of Appeals for the Sixth Circuit. *Turner v. Commissioner*, 410 F.2d 752 (6th Cir. 1969). This case is the basis for all subsequent net gift decisions.

The next major decision was *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972). There the taxpayers transferred a substantial amount of corporate stock directly to one of their sons and in trust for the benefit of two other sons. The three donees signed an agreement whereby they assumed and agreed to pay whatever gift tax was imposed by reason of the gift. The Tax Court stated that the issue, with respect to the gift to the individual, was whether the conditional transfer was a net gift, as con-

tended by the taxpayer, or a part sale, part gift, as contended by the Commissioner. *Id.* at 1366. After considering all of the evidence, the Tax Court concluded that there was nothing in the facts before it which could be construed to indicate anything other than a net gift. *Id.* at 1367. Therefore, relying on various other Tax Court decisions, including *Turner*, the Tax Court concluded that the condition imposed by the transferor that the transferees pay the resulting gift taxes did not alter the result—the transfer constituted a gift. The Tax Court's decision was affirmed, *per curiam*, by the Fifth Circuit Court of Appeals. *Estate of Davis v. Commissioner*, 469 F.2d 694 (5th Cir. 1972).

*Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), was the last decision from the Courts of Appeals before this case was decided by the Eighth Circuit. The taxpayer in *Hirst* was an 81 year old widow who made outright gifts of real property to her son and two grandchildren and a gift in trust to a third grandchild who was still a minor. The son agreed to pay the resulting gift taxes. None of the real property was subject to any lien or indebtedness and its basis was considerably less than the gift taxes. The Tax Court followed *Turner* and rejected the Commissioner's argument that the donee's agreement to pay gift taxes was a taxable event. On appeal a majority of the three-judge panel voted to reverse the Tax Court. However, the case was reheard *en banc* before the decision of the panel was filed, and the Fourth Circuit, by a vote of five to two, affirmed the Tax Court's decision.

The majority opinion of the five judges in *Hirst* is embodied in the combined opinions of Chief Judge Haynsworth and Senior Judge Bryan. The majority found as follows:

> The predominant circumstance here is that this taxpayer did not intend to sell anything; she intended only

> to give her property to her progeny. She did not receive anything for herself; there was no economic gain of any kind accruing to her, except release from the normal tax burden of an owner of real estate.

572 F.2d at 430 (footnote omitted). Based on the above, Judge Haynsworth concluded: "Before the present transaction, Mrs. Hirst owed nothing and by virtue of the transactions she received nothing. She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off." *Id.* at 431. Likewise, Judge Bryan stated:

> For me these facts unalterably demonstrate that the transfer was a gift and nothing more; it did not result in income. The Tax Court's determination to this effect, it seems to me, should be allowed to stand. The partition of the agreement into a gift and an income-producing transaction was not justified in the circumstances.

*Id.* at 431-32.

*Owen v. Commissioner*, 652 F.2d 1271 (6th Cir. 1981), is the most recent case decided in the Courts of Appeals, the decision having been rendered on June 23, 1981. In that case, highly appreciated corporate stock was transferred in trust for the benefit of the grantors' five grandchildren. The trust instrument provided that the trustee was to pay all federal and state gift taxes arising out of the transfers and the tax obligations were discharged with funds borrowed by the trust. The trust subsequently sold a portion of donated gift stock to repay the loans. The Tax Court ruled for the taxpayer and a three-judge panel of the Sixth Circuit affirmed in a two-to-one decision. The Court considered *Owen* indistinguishable from *Turner* and ruled in favor of the taxpayers on the basis of *stare decisis*. *Id.* at 1278.

In view of the other cases decided by the Tax Court and affirmed by the Courts of Appeals, the decision in *Owen* is not surprising. The decision is, however, significant because the Sixth Circuit recognized that its decision in *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974), which is discussed below, did not overrule *Turner*. *Turner* is the law of the Sixth Circuit on net gifts.

The Tax Court and the Courts of Appeals for the Fourth, Fifth, and Sixth Circuits have followed *Turner*, on its facts, in an unbroken line of cases. The decision of the Eighth Circuit in this case is the sole exception. These other cases hold that the donor of a net gift does not recognize income upon the donee's payment of the gift taxes. They hold that the transaction in question is a gift, a transaction without income consequences to the donor. A gift is not a sale in which there is no gain; a gift is not a sale in the first place.

### E. The Cases Upon Which the Eighth Circuit Relied.

As mentioned earlier, in its decision the Eighth Circuit relied on *Johnson v. Commissioner*, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2nd Cir. 1980). Those cases, in turn, were based upon decisions of this Court in *Crane v. Commissioner*, 331 U.S. 1 (1947), and *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), and on lower court decisions in *Malone v. United States*, 326 F.Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972); *First National Industries, Inc. v. Commissioner*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969); and *Simon v. Commissioner*, 285 F.2d 422 (3rd Cir. 1960). Although there was no discussion of the case, the Eighth

Circuit also made reference to the decision in *Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980). These cases are the foundation of the Commissioner's arguments in the net gift cases. *None involves a net gift.*

*Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), involved an interpretation of the Revenue Act of 1918. Petitioner was the executor of the estate of William N. Wood, deceased, who had been the president of American Woolen Company. For the years 1919 and 1920, the company paid all state and federal income taxes on the salaries of the officers, including Mr. Wood. The Commissioner assessed additional income taxes against Mr. Wood on the basis of the company's payment of his taxes. The Supreme Court held that payment of the taxes was in consideration of the services he rendered as an employee and were therefore taxable to him. *Id.* at 729. A net gift was not involved; compensation for services rendered was involved.

In *Crane v. Commissioner*, 331 U.S. 1 (1947), Mrs. Crane acquired property subject to a mortgage equal to its fair market value. She included the mortgage as a part of her basis and depreciated the property for a few years. She then sold the property for $2,500, subject to the mortgage, and reported a gain of $2,500 on the transaction. The Supreme Court held that the taxpayer realized $2,500 upon the sale plus an amount equal to the balance due on the mortgage even though she had no personal liability for the indebtedness. The rationale for its holding was expressed as follows:

> We are . . . concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his

> personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

*Id.* at 14.

The decision in *Crane* was easy. If Mrs. Crane had the right to include the mortgage as a part of her basis in the property, for depreciation purposes, how could she argue realistically that she did not receive a corresponding amount when the property was conveyed? *Crane* involved only the *amount* of the gain; the taxability of the transaction was not in issue. A net gift was not involved; gain from the sale of property was involved.

The reasons *Crane* does not apply to this case are well articulated in the portion of the Commissioner's brief in *Johnson v. Commissioner*, in which he distinguished *Turner*. There, the Commissioner said:

> *Turner* involved altogether different transactions. . . . We submit that the *Turner* decision is inapplicable here, but if this Court concludes that *Turner* is relevant, we submit that it should not be followed for the applicability of *Crane* and *First National Industries* to the case is far clearer. (p. 6)
>
> * * *
>
> *Turner* is distinguishable from [*Johnson*]. . . . *Turner* did not involve the *Crane* and *First National Industries* - type transactions as [*Johnson* does]. . . . [T]he transferror in *Turner* did not realize any *gain* at the time of the transfer, when she received a mere unsecured promise to pay the gift tax due, [accordingly] the [*Turner*] case [does] not fit any familiar

> pattern such as the *Crane*-type transaction involved here. (p. 15)
>
> * * *
>
> It bears repeating that these [*Johnson*] cases fit the classic *Crane*-type mold, rather than that of *Turner*, and should be decided on that basis. (p. 20)
>
> * * *
>
> Even apart from the applicability of *Crane*, moreover, a decision that *Turner* controls the outcome here would constitute an effective overruling of this Court's own decision in *First National Industries*. (p. 21)

The reason *Johnson* fits *Crane* is that a pre-existing liability was discharged. That was not the case in *Turner*, nor is it here.

In *Malone v. United States*, 326 F.Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972), the taxpayer made a gift of land subject to $32,000 in mortgages which secured personal borrowings of the taxpayer. The funds had been used for his personal benefit. Principal and interest on this indebtedness was subsequently retired by the donee from earnings off the land. Because of the taxpayer's personal exclusions, no gift taxes were payable. The Commissioner asserted that the transaction was part gift and part sale. The Court agreed, concluding that the trust had effectively assumed the donor's obligations on the notes and that he had thereby secured a discharge of his personal indebtedness which constituted taxable gain. A net gift was not involved; a sale or exchange was involved.

In *First National Industries, Inc. v. Commissioner*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969), the taxpayer was one of six corporations owned or con-

trolled by a charitable foundation. The taxpayer owned stock in an entirely separate company which it pledged as collateral for a $750,000 bank loan. The pledged stock was then donated to the charitable foundation. The foundation sold the stock for $700,000 and used the proceeds to pay off loans it had obtained from the other related corporations. Those corporations were indebted to the taxpayer and they paid the $700,000 received from the foundation to the taxpayer on their debts. The taxpayer then used the funds to retire the original bank loan. The Court found in favor of the government:

> We hold that the determination of the Tax Court that the transaction whereby petitioner transferred the stock to the Foundation was a sale by petitioner of the stock for an amount of at least $700,000 and that petitioner thereby realized a capital gain from the transaction in its fiscal year ended January 31, 1959, to be supported by substantial evidence and not clearly erroneous.

404 F.2d at 1186. A net gift was not involved; a sale of property was involved.

In *Simon v. Commissioner*, 32 T.C. 935 (1959), *aff'd*, 285 F.2d 422 (3rd Cir. 1960), the taxpayer purchased the RKO building in Philadelphia. He placed a non-recourse mortgage on the property in the amount of $120,000 and shortly thereafter conveyed the property subject to the mortgage to a corporation as a contribution to its capital. The Tax Court found, as its ultimate fact determination, that a sale took place, and that finding was affirmed by the Court of Appeals. A net gift was not involved; a sale of property was involved.

*Johnson v. Commissioner*, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974),

was a typical *Crane* case except that the property was given away rather than sold. In *Johnson*, the taxpayers obtained a $200,000 loan secured by a pledge of corporate stock. Three days later the stock was transferred in trust for the benefit of the taxpayers' children. The taxpayers' loan was paid off by the trust and the taxpayers (not the donees) paid the gift taxes of approximately $150,000, leaving them with $50,000 in cash and no obligation on the note. The taxpayers reported no income from the transaction. The Commissioner assessed an income tax deficiency based upon the taxpayers' receipt of $200,000 from the discharge of the loan.

In the resulting litigation, the taxpayers conceded they had realized income to the extent of $50,000, but maintained they did not realize income to the extent loan proceeds had been used to pay gift taxes. The taxpayers argued that their transaction was in substance no different than the net gift made in *Turner* and that no income should be recognized to the extent of the gift taxes. The Tax Court disagreed, holding that to the extent the loan exceeded their basis in the property, there was a sale. 59 T.C. at 812. The Sixth Circuit affirmed. 495 F.2d 1079.

The *Johnson* case differs from *Malone v. United States*, only in that part of the loan proceeds were used to pay the gift taxes. The taxpayer conceded he recognized gain to the extent of the excess, *i.e.* $50,000 and he thus conceded that the transaction was taxable. What Johnson was seeking actually was a deduction in the amount of $150,000 for the gift taxes he paid. Such a deduction is specifically denied by section 275 of the Internal Revenue Code and Johnson had no case. A net gift was not involved in *Johnson;* a sale was involved.

The Court of Appeals in *Johnson* disposed of the *Turner* argument as follows: "[T]he *Turner* case does

not support the taxpayers' position. *Turner* has no precedential value beyond its peculiar fact situation, in view of the Commissioner's concessions in that case both in the Tax Court and on appeal to this Court." 495 F.2d at 1086.

The "concessions" referred to were admissions by the Commissioner that the transfers to the trusts were not part gift, part sale. No concessions were made with respect to the net gifts made in *Turner* to individuals, however, and the *Turner* ruling as to net gifts remained intact. In every subsequent net gift case, the Commissioner has claimed that *Johnson* overruled *Turner*. That argument has now been laid to rest with the decision in *Owen v. Commissioner*. (See discussion at pp. 16-17, *supra*.)

*Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980), also involved a *Crane*-type transaction. The taxpayer in *Evangelista* owned a fleet of automobiles which were leased to the United States government. The automobiles were encumbered by an indebtedness of approximately $100,000 on which the taxpayer was personally liable. He owned the automobiles for parts of two tax years during which he claimed approximately $68,000 in depreciation deductions. The automobiles and the government leases were then transferred to a trust established for the benefit of his children. At the time of the transfer, the taxpayer's basis in the automobiles was approximately $34,000, and the unpaid balance of the indebtedness was approximately $67,000. The taxpayer did not report any income in connection with the transfer and he did not report the transfer as a gift.

The Seventh Circuit determined that gain had been realized to the extent the assumed indebtedness exceeded the taxpayer's adjusted basis in the automobiles. The Court held there was no evidence in the record to support

the taxpayer's contention that a gift had been made and, accordingly, there was no need to consider the taxpayer's argument that he had made a net gift. The Tax Court had determined that a taxable disposition had taken place and the Seventh Circuit agreed. *Id.* at 1224. A net gift was not involved; a sale or exchange was involved.

The taxpayer in *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980), made a gift of land to a trust for the benefit of three grandchildren. The trust assumed almost $800,000 in pre-existing, non-recourse debt which encumbered the land and approximately $125,000 of pre-existing expenses incurred by the donor. The donor had retained more than $200,000 of mortgage proceeds for his personal use and he reported a gift of approximately $15,000. The Tax Court found the transfer to be part gift, part sale. 72 T.C. at 791. The Second Circuit affirmed following the Sixth Circuit's lead in *Johnson* and refusing to apply *Turner* to this non-net gift transaction. 634 F.2d 12. The Court found there was an explicit "sale" element to the transaction. *Id.* at 17. A net gift was not involved; a sale was involved.

All of the cases relied upon by the Eighth Circuit, with the exception of *Old Colony Trust Co. v. Commissioner*, 219 U.S. 716 (1929), involve the conveyance of property subject to an indebtedness. The taxable event in each of these cases is the conveyance; it is not payment of the obligation by the transferee. The Commissioner does not assert, and the Eighth Circuit did not find, that the transfers by gift in these cases were the taxable events. The Eighth Circuit held the taxable event to be the subsequent discharge of the gift tax liability. Only *Old Colony Trust Co.*, even by analogy, supports that holding; *Old Colony Trust Co.* is not applicable because the payment of taxes in that case was specifically in consideration of services rendered.

The payments in this case by the donees is in satisfaction of their obligations under agreements made in connection with nontaxable transfers.

Thus, the cases relied on by the Eighth Circuit do not support its economic benefit theory. *Crane* and *Old Colony Trust Co.* involve traditional taxable transactions. *Johnson, Levine,* and *Evangelista* were all decided by the Tax Court after *Turner* and each involved a sale. The Tax Court has consistently followed *Turner,* and it found no difficulty reconciling its subsequent decisions in *Johnson, Levine,* and *Evangelista* with *Turner.* A net gift is not a sale. In both cases before the Court here, the Tax Court found that a gift had been made of the entire property (Appendix B to Petition for a Writ of Certiorari at A14; Appendix C to Petition for a Writ of Certiorari at A17); there was no finding of a part gift, part sale.

### F. Discharge of the Gift Tax Liability in a Net Gift Is Made by the Donor.

The "economic benefit" to the donor invented by the Commissioner and adopted by the Eighth Circuit is the discharge of his gift tax liability by the donee. *Diedrich v. Commissioner,* 643 F.2d at 504. As explained earlier, there is no economic benefit to the donor. Similarly, there is no independent taxable value received by the donor because payment of the taxes is tendered by the donee. Section 2501, I.R.C. 1954, imposes a tax "on the transfer of property by gift." Section 2502(d) states that the tax shall be paid by the donor. Although legal responsibility for attending to payment is thus placed on the donor, nowhere does the Code require tender of payment by the donor or, for that matter, specify the source of funds to be used.

The donor of a net gift makes legally enforceable arrangements for payment of the gift taxes. He supplies

funds with which the payment can be made. The donee accepts those funds and holds them subject to an obligation to tender payment of the gift taxes. When he does so, he is performing a duty on behalf of the donor and the payment is for the account of the donor. It is immaterial that the donee may choose to use other property for payment of the taxes. *See, Estate of Morgan v. Commissioner*, 37 T.C. 981, 985 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963). Neither the donor nor the Treasury is affected.

Assume a donor in a 25% gift tax bracket makes a net gift of $1,000 in cash. The gift is $800; $200 and has been deposited with the donee to cover the tax. The donor has not incurred an income tax liability when the donee tenders the gift taxes to the Treasury.[4] *Krause v. Commissioner*, 56 T.C. at 1248. This is not a taxable transaction in which there is no gain; it is not a taxable transaction at all. Legally and economically, the donor has paid the gift taxes. We submit that the transaction is no different substantively because low basis corporate stock is given rather than cash.

If an employee, in exchange for services rendered, directs his employer to pay the employee's debt, the payment is income to the employee. It is compensation for services rendered. *Old Colony Trust Co.* If, however, a mother deposits money with her son and directs him to pay her gift taxes, the payment is not income to the mother. Discharge of the tax liability—as opposed to tender of payment—is made by the mother.

The donee's status as a conduit for payment of the gift taxes was recognized in *Turner* where the Tax Court stated

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4. In footnote 13 to his brief before the Eighth Circuit in *Diedrich*, the Commissioner conceded no taxable income would be generated in this situation.

that the effect of the net gift transfer is to reserve a right to use a portion of the property. 49 T.C. at 363. That rationale has not been criticized in the subsequent decisions considering *Turner*. It is of no importance to the donor or to the Treasury whether the donee pays the taxes (a) by selling some of the property, (b) by borrowing the funds, or (c) by using funds independently obtained.

**G. The Role of Stare Decisis.**

Reversal of the Eighth Circuit is appropriate under the principles of fair play, uniform administration of the tax laws, and *stare decisis*. We have analyzed the past net gift decisions and the cases relied upon by the Eighth Circuit in detail. The net gift decisions all favor the taxpayer. None of the cases relied on by the Eighth Circuit involves a net gift; all involve traditional income producing transactions. Whatever may be said of the merits of the Commissioner's position, the matter has gone so far, for so long, that it should not now be reversed.

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

*United States v. Byrum*, 408 U.S. 125, 134 (1972). "Things have gone too far by now to wipe the slate clean and start all over again." *Hirst v. Commissioner*, 63 T.C. at 315.

In *Estate of Henry v. Commissioner*, a net gift case, the Tax Court recognized that it would be unfair to impose a tax upon a taxpayer who in good faith relied on existing law:

> Despite this overwhelming precedent to the contrary, respondent [Commissioner] continues to urge that we change our long-established position on this issue in order to sustain a tax deficiency . . . against a taxpayer who justifiably relied upon that clear precedent in making the gifts which are the subject of this case. . . . In these circumstances, under the principle of stare decisis and fair play with a taxpayer who has relied upon our prior opinions, which opinions have been affirmed by higher courts or in respect of which appeals have been dismissed, we must follow the *Turner* case and hold that petitioner did not realize taxable income as a result of the conditional transfers here in dispute.

69 T.C. at 675.

In *Dobson v. Commissioner*, 320 U.S. 489 (1943), the Supreme Court stated with respect to decisions of the Tax Court:

> Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both law and facts. Whatever latitude exists in resolving questions such as those of proper accounting, treating a series of transactions as one for tax purposes, or treating apparently separate ones as single in their tax consequences, exists in the Tax Court and not in regular courts; when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax

> Court must stand. . . . In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.

*Id.* at 501-02.

Since *Turner* was affirmed by the Sixth Circuit in 1971, there have been at least ten Tax Court decisions holding that there is no income tax consequence in a pure net gift situation. Judge Bryan in the *Hirst* decision cited *Dobson* and stated that failure to follow those Tax Court decisions "seems to me to be a complete disregard of the Supreme Court's directive for treatment of the Tax Court decisions both on the facts and on the law, especially when 'uniform administration would be promoted by conforming to them where possible.' " 572 F.2d at 434. The Tax Court's decisions on net gifts have been uniform in finding no tax on the part of the net gift donor and those findings are supported by the law and the facts and should be followed: "[The Tax Court's] decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body'." 320 U.S. at 501.

Although *stare decisis* does not apply here in the technical sense, in view of the lack of a Supreme Court decision directly in point, the net gift position of the Tax Court and the Courts of Appeals for the Fourth, Fifth, and Sixth Circuits was established well before the decision of the Eighth Circuit in this case and we submit it should be

followed here. Justice Brandeis made the point better than we:

> Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation.

*Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (citation and footnote omitted).

The *Turner* decision and the subsequent net gift cases are consistent with the theories initially urged by the Commissioner and if *Turner* was incorrectly decided, as the Commissioner asserts, much of the responsibility is his. In *Estate of Staley v. Commissioner*, 47 B.T.A. 260 (1942), *aff'd*, 136 F.2d 368 (5th Cir.), *cert. denied*, 320 U.S. 786 (1943), the taxpayer had contributed corporate stock in trust for the benefit of his children, reserving to himself a specified amount of trust income which he used in paying the gift taxes. The Commissioner determined that the taxpayer had retained an income interest in the property transferred into trust which was taxable to him as ordinary income. The taxpayer claimed that his conveyances were not gifts, but were sales of securities for a purchase price equal to the retained income interest. The Fifth Circuit disagreed:

> The realities of this arrangement are not difficult to ascertain. This was no sale for an inadequate consideration; it was intended to be, and actually was, a gift of the entire corpus and of all the income except an amount necessary to assist in paying the gift taxes. Expressed differently, it was an outright transfer for no consideration, but with a reservation to the donor of a portion of the income.

*Id.* at 369-70 (footnotes omitted). It is interesting to note that in this case the gift taxes were not paid by the donee; the funds for paying gift taxes were paid back to the donor. Yet, the Commissioner—not the donor— successfully urged that there had been only a gift; that no taxable transfer of the stock had occurred.

*Estate of Sheaffer v. Commissioner*, 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963), involved the creation of trusts for the benefit of the grantor's children. The trust agreements provided that the trustee was to assume and pay all federal and state gift taxes resulting from the transfers. Dividend income on the gift stock was applied by the trustee in payment of the gift taxes and the Commissioner asserted that the dividend income was taxable income to the donors under section 677 of the Internal Revenue Code.[5] The Tax Court and the Eighth Circuit agreed on the basis of *Estate of Staley v. Commissioner*. The Commissioner did not contend that a sale of the stock had taken place. Indeed, the Commissioner could not make such a claim and still have the income taxable to the grantors as ordinary income under section 677.

In *Estate of Morgan v. Commissioner*, 37 T.C. 981 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963), the grantor transferred stock, valued at approximately $1 million, into an irrevocable trust for the benefit of her children and grandchildren. The trust agreement imposed upon the trustees the duty of paying the gift taxes incurred in connection with the gift. The amount of the taxes was determined on a net basis and the resulting gift taxes of approximately $185,000 were paid by the trustee. The trustees borrowed the necessary

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5. I.R.C. §677 provides that income of a trust which may be distributed to the grantor is taxable to him.

funds to pay the taxes in 1956, pledging the gift stock as security for the loan. In 1957 and 1958, the trustees made payments on the loan with dividends received from the stock. The Commissioner asserted that these amounts were taxable to the grantor under section 677.

The Tax Court found that the trustees' obligation with respect to the gift taxes terminated in 1956, when the taxes were paid, and that the grantor thereafter had no further interest in the trust. Accordingly, no portion of the trust income was taxable to her:

> [The donor's] gift tax obligation was paid when due and that is the sole benefit she would have received no matter what method had been chosen by the trustees to obtain funds for this purpose. The manner of obtaining the money was chosen independently by the trustees who were authorized to select whatever method they deemed advisable. Of course, the fact that the trustees chose to obtain money by borrowing and then repaying the loan from income means the trust retained more corpus and less income. This, however, did not benefit the decedent because she retained no interest in the trust and could not recover the corpus. Therefore, since the decedent received no benefit from the fact that the trustees borrowed to discharge her gift tax obligation and repaid the loan from trust income, she cannot be held to have constructively received the income used to repay the loan.

37 T.C. at 985. Once again, the Commissioner made no claim that a sale or other taxable disposition of the stock had been made because to do so would be to defeat his claim that the donor realized ordinary income under section 677. The Commissioner did not even claim that the taxable event was payment of the gift taxes.

The most significant concession of the Commissioner, however, was made in *Turner*. In *Turner*, net gifts had been made to both individual transferees and to trusts created for the benefit of the grantor's grandchildren. The trusts and the individuals agreed to pay the gift taxes. In his brief, the Commissioner conceded that the transfers in trust were in no part sales. 49 T.C. at 362. The primary question presented was whether the transfer to the individuals was a net gift or was a part sale, part gift as argued by the Commissioner. The Tax Court rejected the distinction urged by the Commissioner between the transfers to trusts and those to individuals:

> He distinguishes the two classes of transfers on the basis that the trustees were not personally liable for the tax while the individual transferees personally promised to pay the tax. He concludes that in this latter class of transfers Pamela did not retain any interest in the property transferred but accepted instead the personal promises of the recipients.

*Id.* at 362-63. The Tax Court found the transfers substantively identical and the claimed distinction artificial and unpersuasive. The Tax Court found as a fact that the donor intended to make a net gift, the value of the shares less the value of the gift tax payable on the transfer, and that her gifts did not result in a taxable gain to her. *Id.* at 363. The *Turner* Court relied upon the earlier decisions in *Estate of Staley v. Commissioner*, *Estate of Sheaffer v. Commissioner*, and *Estate of Morgan v. Commissioner*.

We believe the net gift cases were correctly decided. Furthermore, we believe that thirteen years of tax precedent based upon decisions of the Tax Court should not be reversed, especially when the Commissioner's own theories were largely responsible for that precedent. Finally, we urge that, even if the Supreme Court would find for the

Commissioner if this were a case of first impression, the principles of fair play and *stare decisis* require that such a ruling operate prospectively only, rather than allowing a penalty to fall on petitioners who justifiably relied on *Turner* and its progeny. *See, Chevron Oil Co. v. Hudson*, 404 U.S. 97 (1971).

**H. Congressional Action.**

In the Tax Reform Act of 1976, Congress considered the possibility of tax avoidance when low basis, highly appreciated property is given to taxpayers in relatively low income tax brackets. Section 644 was added to the Internal Revenue Code to place limited restrictions on this "bracket advantage." Section 644 imposes an additional tax on a trust which sells property within two years after the property is transferred to the trust. The tax is equal to the difference between the tax that would have been imposed on the grantor, had he made the sale, and the tax imposed on the trust.

Thus, the bracket advantage is eliminated in this specific situation. The adoption of Section 644 is highly pertinent to the net gift question in this case. First, Congress imposed the tax only with respect to transfers in trust. Transfers to individuals are unaffected. Second, the additional tax is not imposed until a sale takes place, further recognition of the general principle that sale or conversion of the property must occur before gain is recognized. Third, the tax is not imposed at all if the property is held by the trust for more than two years. The imposition of these limited restrictions on the tax bracket advantage clearly implies that Congress did not feel that further regulation of gifts through the income tax code was necessary or appropriate. Judicial legislation in this area is inappropriate in view of this congressional action.

## CONCLUSION

The Eighth Circuit in this case erroneously ruled that the taxpayers in *Grant* and in *Diedrich* recognized substantial economic benefits, taxable to them as income under Subtitle A of the Internal Revenue Code, from the payment of gift taxes by the donees of petitioners' net gifts. The decisions of the Tax Court in *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), and in *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), were correct. We request that the decision of the Eighth Circuit in this case be reversed with instructions that the decisions of the Tax Court in favor of the petitioners be reinstated. However, if the Court finds the analysis of the decision below correct, we request that the decision be made prospective only and not applicable to petitioners in this case or to other taxpayers who have justifiably relied upon *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd*, 410 F.2d 752 (6th Cir. 1969).

Respectfuly submitted,

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# APPENDIX

## INTERNAL REVENUE CODE OF 1954 (U.S.C.)

### § 61. Gross income defined

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) CROSS REFERENCES.—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

**§ 275. Certain taxes**

(a) GENERAL RULE.—No deduction shall be allowed for the following taxes:

(1) Federal income taxes, including—

(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

(C) the tax withheld at source on wages under section 3402.

(2) Federal war profits and excess profits taxes.

(3) Estate, inheritance, legacy, succession, and gift taxes.

(4) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

(5) Taxes on real property, to the extent that section 164(d) requires such taxes to be treated as imposed on another taxpayer.

(6) Taxes imposed by chapters 41, 42, 43, and 44.

(b) CROSS REFERENCE.—

For disallowance of certain other taxes, see section 164(c).

**§ 644. Special rule for gain on property transferred to trust at less than fair market value**

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—If—

(A) a trust (or another trust to which the property is distributed) sells or exchanges property at a gain not more than 2 years after the date of the initial transfer of the property in trust by the transferor, and

(B) the fair market value of such property at the time of the initial transfer in trust by the transferor exceeds the adjusted basis of such property immediately after such transfer,

there is hereby imposed a tax determined in accordance with paragraph (2) on the includible gain recognized on such sale or exchange.

(2) AMOUNT OF TAX.—The amount of the tax imposed by paragraph (1) on any includible gain recognized on the sale or exchange of any property shall be equal to the sum of—

(A) the excess of—

(i) the tax which would have been imposed under this chapter for the taxable year of the transferor in which the sale or exchange of such property occurs had the amount of the includible gain recognized on such sale or exchange, reduced by any deductions prop-

erly allocable to such gain, been included in the gross income of the transferor for such taxable year, over

(ii) the tax actually imposed under this chapter for such taxable year on the transferor, plus

(B) if such sale or exchange occurs in a taxable year of the transferor which begins after the beginning of the taxable year of the trust in which such sale or exchange occurs, an amount equal to the amount determined under subparagraph (A) multiplied by the annual rate established under section 6621.

The determination of tax under clause (i) of subparagraph (A) shall be made by not taking into account any carryback, and by not taking into account any loss or deduction to the extent that such loss or deduction may be carried by the transferor to any other taxable year.

(3) TAXABLE YEAR FOR WHICH TAX IMPOSED.—The tax imposed by paragraph (1) shall be imposed for the taxable year of the trust which begins with or within the taxable year of the transferor in which the sale or exchange occurs.

(4) TAX TO BE IN ADDITION TO OTHER TAXES.—The tax imposed by this subsection for any taxable year of the trust shall be in addition to any other tax imposed by this chapter for such taxable year.

(b) DEFINITION OF INCLUDIBLE GAIN.—For purposes of this section, the term "includible gain" means the lesser of—

(1) the gain recognized by the trust on the sale or exchange of any property, or

(2) the excess of the fair market value of such property at the time of the initial transfer in trust by the transferor over the adjusted basis of such property immediately after such transfer.

(c) CHARACTER OF INCLUDIBLE GAIN.—For purposes of subsection (a)—

(1) the character of the includible gain shall be determined as if the property had actually been sold or exchanged by the transferor, and any activities of the trust with respect to the sale or exchange of the property shall be deemed to be activities of the transferor, and

(2) the portion of the includible gain subject to the provisions of section 1245 and section 1250 shall be determined in accordance with regulations prescribed by the Secretary.

(d) SPECIAL RULES.—

(1) SHORT SALES.—If the trust sells the property referred to in subsection (a) in a short sale within the 2-year period referred to in such subsection, such 2-year period shall be extended to the date of the closing of such short sale.

(2) SUBTITUTED BASIS PROPERTY.—For purposes of this section, in the case of any property held by the trust which has a basis determined in whole or in part by reference to the basis of any other property which was transferred to the trust—

(A) the initial transfer of such property in trust by the transferor shall be treated as having occurred on the date of the initial transfer in trust of such other property,

(B) subsections (a)(1)(B) and (b)(2) shall be applied by taking into account the fair market value and the adjusted basis of such other property, and

(C) the amount determined under subsection (b)(2) with respect to such other property shall be allocated (under regulations prescribed by the Secretary) among such other property and all properties held by the trust which have a basis determined in whole or in part by reference to the basis of such other property.

(e) EXCEPTIONS.—Subsection (a) shall not apply to property—

(1) acquired by the trust from a decedent or which passed to a trust from a decedent (within the meaning of section 1014), or

(2) acquired by a pooled income fund (as defined in section 642(c)(5)), or

(3) acquired by a charitable remainder annuity trust (as defined in section 664(d)(1)) or a charitable remainder unitrust (as defined in sections 664(d)(2) and (3)), or

(4) if the sale or exchange of the property occurred after the death of the transferor.

(f) SPECIAL RULE FOR INSTALLMENT SALES.—If the trust reports income under section 453 on any sale or exchange to which subsection (a) applies, under regulations prescribed by the Secretary—

(1) subsection (a) (other than the 2-year requirement of paragraph (1)(A) thereof) shall be applied as if each installment were a separate sale or

exchange of property to which such subsection applies, and

(2) the term "includible gain" shall not include any portion of an installment received by the trust after the death of the transferor.

**§ 677. Income for benefit of grantor**

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) OBLIGATIONS OF SUPPORT.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

**§ 1001. Determination of amount of and recognition of gain or loss**

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other dispositionf of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) RECOGNITION OF GAIN OR LOSS.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) INSTALLMENT SALES.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(e) CERTAIN TERM INTERESTS.—

(1) IN GENERAL.—In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014 or 1015 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) TERM INTEREST IN PROPERTY DEFINED.—For purposes of paragraph (1), the term "term interest in property" means—

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) EXCEPTION.—Paragraph (1) shall not apply to a sale or other disposition which is a part of a

transaction in which the entire interest in property is transferred to any person or persons.

(f) CROSS REFERENCE.—

For treatment of certain expenses incident to the sale of a residence which were deducted as moving expenses by the taxpayer or his spouse under section 217(a), see section 217(e).

**Sec. 2501 [1954 Code].** (a) TAXABLE TRANSFERS.—

(1) GENERAL RULE.—A tax, computed as provided in section 2502, is hereby imposed for each calendar quarter on the transfer of property by gift during such calendar quarter by an individual, resident or nonresident.

(2) TRANSFERS OF INTANGIBLE PROPERTY.—Except as provided in paragraph (3), paragraph (1) shall not apply to the transfer of intangible property by a nonresident not a citizen of the United States.

(3) EXCEPTIONS.—Paragraph (2) shall not apply in the case of a donor who at any time after March 8, 1965, and within the 10-year period ending with the date of transfer lost United States citizenship unless—

(A) such donor's loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U. S. C. 1401(b). 1482, 1487), or

(B) such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

(4) BURDEN OF PROOF.—If the Secretary establishes that it is reasonable to believe that an individual's

loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar quarter in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual.

(5) TRANSFERS TO POLITICAL ORGANIZATIONS.—Paragraph (1) shall not apply to the transfer of money or other property to a political organization (within the meaning of section 527(e)(1)) for the use of such organization.

(b) CERTAIN RESIDENTS OF POSSESSIONS CONSIDERED CITIZENS OF THE UNITED STATES.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "citizen" of the United States within the meaning of that term wherever used in this title unless he acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(c) CERTAIN RESIDENTS OF POSSESSIONS CONSIDERED NONRESIDENTS NOT CITIZENS OF THE UNITED STATES.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "nonresident not a citizen of the United States" within the meaning of that term wherever used in this title, but only if such donor acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(d) CROSS REFERENCE.—

(1) For increase in basis of property acquired by gift for gift tax paid, see section 1015(d).

(2) For exclusion of transfers of property outside the United States by a nonresident who is not a citizen of the United States, see section 2511(a).

**Sec. 2502 [1954 Code].** (a) COMPUTATION OF TAX.—The tax imposed by section 2501 for each calendar quarter shall be an amount equal to the excess of—

(1) a tentative tax, computed in accordance with the rate schedule set forth in section 2001(c), on the aggregate sum of the taxable gifts for such calendar quarter and for each of the preceding calendar years and calendar quarters, over

(2) a tentative tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable gifts for each of the preceding calendar years and calendar quarters.

(b) CALENDAR QUARTER.—Wherever used in this title in connection with the gift tax imposed by this chapter, the term "calendar quarter" includes only the first calendar quarter of the calendar year 1971 and succeeding calendar quarters.

(c) PRECEDING CALENDAR YEARS AND QUARTERS.—Wherever used in this title in connection with the gift tax imposed by this chapter—

(1) The term "preceding calendar years" means calendar years 1932 and 1970 and all calendar years intervening between calendar year 1932 and calendar year 1970. The term "calendar year 1932" includes only the portion of such year after June 6, 1932.

(2) The term "preceding calendar quarters" means the first calendar quarter of calendar year 1971 and all calendar quarters intervening between such calendar quarter and the calendar quarter for which the tax is being computed.

(d) TAX TO BE PAID BY DONOR.—The tax imposed by section 2501 shall be paid by the donor.

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CLERK

No. 80-2204

# In the Supreme Court of the United States

OCTOBER TERM, 1981

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VICTOR P. DIEDRICH AND
FRANCES T. DIEDRICH, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON WRIT OF CERTIORARI TO THE*
*UNITED STATES COURT OF APPEALS*
*FOR THE EIGHTH CIRCUIT*

---

## BRIEF FOR THE RESPONDENT

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## QUESTION PRESENTED

Whether petitioners' transfers of appreciated property to various donees, on the condition that the donees pay the gift tax liability imposed upon petitioners, resulted in taxable gain to petitioners to the extent that the gift taxes paid by the donees exceeded petitioners' bases in the property.

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# In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 80-2204

VICTOR P. DIEDRICH AND
FRANCES T. DIEDRICH, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
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*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE*
*UNITED STATES COURT OF APPEALS*
*FOR THE EIGHTH CIRCUIT*

## BRIEF FOR THE RESPONDENT

### OPINIONS BELOW

The memorandum findings of fact and opinion in *Diedrich* v. *Commissioner* (Pet. App. A17-A22) and the memorandum opinion in *Grant* v. *Commissioner* (Pet. App. A12-A16) are not officially reported. The opinion of the court of appeals (Pet. App. A1-A11) is reported at 643 F.2d 499.

### JURISDICTION

The judgments of the court of appeals were entered on March 4, 1981 (Pet. App. A23-A24). The orders denying petitions for rehearing and suggestions for rehearings en banc were entered on March 27, 1981 (Pet. App.

A25-A26). The petitions for a writ of certiorari were filed on June 25, 1981, and were granted on October 5, 1981. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 61, 451, 644, 671, 1001, 1015, 2501 and 2502 of the Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)) are set forth at Appendix, *infra*, 1a-8a. The relevant provisions of §§ 1.1001-1(e) and 1.1015-4 of the Treasury Regulations on Income Tax (26 C.F.R.), are set forth at Appendix, *infra*, 8a-9a.

## STATEMENT

### A. The Facts of These Cases

1. *Diedrich.* On April 1, 1972, petitioner Victor P. Diedrich made a gift of 51,073 shares of voting and nonvoting common stock of Owatonna Manufacturing Company, Inc. (OMC), to or for the benefit of his three adult children, Eugene F. Diedrich, JoAnn D. Petkus, and Madelyn D. Smith. On the same day, petitioner Frances T. Diedrich made the following gifts: 17,085 shares of OMC voting and nonvoting common stock to her son Eugene; a total of 17,024 shares of nonvoting common stock to irrevocable trusts for the benefit of her two daughters JoAnn D. Petkus and Madelyn D. Smith. At the time the gifts were made, Eugene, acting for himself and as the trustee of the Petkus and Smith Trusts, signed three agreements on behalf of each of the donees, promising that as a condition of receiving the gifts, each donee would pay its share of the federal and state gift taxes for which petitioners were liable (Pet. App. A17-A18).

For federal gift tax purposes, petitioners agreed to treat their gifts as if made one-half by each and so reported the gifts for the second quarter of 1972. Petitioners valued the OMC stock that they transferred to Eugene and to the Petkus and Smith Trusts at $7.80 per share. Accordingly, the gross amount of the gift of 51,073

shares of OMC stock reported on the return was $398,369. The donees paid the resulting federal gift tax liability of $62,992 in 1972 (Pet. App. A18).[1]

In order to satisfy petitioners' federal gift tax liability which they promised to discharge, Eugene, acting in his individual capacity and as trustee of the Petkus and Smith Trusts, borrowed $62,992 from OMC. The total sum of the loan was advanced in three separate checks, each payable to the respective borrower. On or before August 15, 1972, Eugene paid the federal gift tax individually and as trustee of the trusts, by endorsing these checks to the order of the Internal Revenue Service (Pet. App. A19).

The Petkus and Smith Trusts each sold 2,728 shares of OMC stock to OMC in December 1972 at $7.80 per share, in order to pay the principal and interest on their loans from OMC. Eugene paid the principal and interest on the loans from OMC with his personal funds. On or before April 15, 1973, the trusts sold additional shares of OMC stock at $7.80 per share to pay their respective portions of petitioners' Minnesota gift tax liability. Eugene again used his personal funds to pay his portion of petitioners' state gift tax (Pet. App. A19).[2]

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[1] The donees also paid Minnesota gift taxes of $18,508 in 1973 (Pet. App. A18-A19).

[2] On audit of petitioners' federal gift tax returns in 1974, the Commissioner of Internal Revenue determined that the value of the OMC stock transferred to the donees was $13 per share at the time of the gift, and not the $7.80 per share figure reported. Accordingly, the Service determined that the value of the 51,073 shares was $663,949, and additional federal and Minnesota gift taxes of $64,213 were paid by the donees in 1975 (Pet. App. A19).

After the audit, which resulted in an increase in the gift tax liabilities of petitioners, OMC agreed to pay the Petkus and Smith Trusts additional consideration for the purchase of their stock in December 1972. OMC increased its purchase price from $7.80 to $13 per share to conform to the revised value and also agreed to pay interest to the trusts from the date of the sale to the date of payment of such additional consideration. Each trust used the additional amounts paid by OMC to pay its share of the federal and Minnesota

Petitioners had a basis of $1 per share in the OMC stock that they transferred to Eugene and the trusts for the benefit of their daughters. On their 1972 federal income tax return, petitioners did not report any income as a result of their transfers of the stock on the condition that the donees pay the gift taxes for which petitioners were liable. On audit, the Commissioner of Internal Revenue determined that petitioners received taxable gain to the extent that their gift tax liabilities discharged by the donees exceeded their bases in the transferred stock. A deficiency in petitioners' taxable income of $5,959 was accordingly determined (Pet. App. A3, A20-A21).[3]

2. *United Missouri Bank.* Petitioner is the executor of the Estate of Frances D. Grant. In August 1970, when she was more than 90 years of age, the decedent[4] made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant. Petitioner's basis in the certificates was $4,857. The gift was made on the condition that

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gift tax deficiencies assessed against petitioners. Eugene paid his portion of the additional taxes from his personal funds (Pet. App. A19-A20).

If the judgment below is affirmed, petitioners agree that they will be required to recognize additional gain in 1975 to take these additional amounts of gift tax into account, and that they will be further required to recognize additional gain in 1973, representing the donees' payment of the Minnesota gift taxes.

[3] The deficiency of $5,959 was computed as follows (Pet. App. A3):

| | |
|---|---|
| Gift tax paid in 1972 | $62,992 |
| Less: Bases in stock transferred | 51,073 |
| Long term capital gain | 11,919 |
| 50% deduction for long-term capital gain | 5,959 |
| Increase in taxable income | $ 5,959 |

[4] When the context so indicates, the term "petitioner" refers to the decedent Frances D. Grant, rather than her executor, United Missouri Bank.

William pay the gift taxes for which petitioner was liable. On or about April 15, 1971, petitioner reported the gift on her gift tax return, which showed gift taxes of $106,334.32 owing as a result of the gift (Pet. App. A14).

In January 1971, petitioner gave her son an additional 40,000 voting trust certificates in BMA Corporation, on the same condition that he pay the gift taxes shown to be due on her gift tax return. Petitioner's basis in these certificates was $3,885.60. The gift taxes due as a result of the second gift were $126,295.77 (Pet. App. A14-A15).[5]

On audit of petitioner's income tax returns for 1970 and 1971, the Commissioner of Internal Revenue determined that petitioner realized long-term capital gain from the transfer of the voting trust certificates to her son William, in the amount that her gift tax obligation discharged by her son exceeded her basis in the property. The Commissioner accordingly determined to increase petitioner's taxable income by $111,943.75 (Pet. App. A3, A14-A15).[6]

### B. The Proceedings Below

Petitioners Diedrich and Grant thereafter sought redetermination in the Tax Court of the income tax deficiencies determined as a result of their transfers of

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[5] Although the Tax Court did not determine the fair market value of the certificates at the time of the gift, the substantial gift tax paid ($232,630.09) indicates that the value of the certificates approximated $1 million. See Section 2502 of the Internal Revenue Code of 1954.

[6] The increase in petitioner's taxable income was computed as follows (Pet. App. A3):

| | |
|---|---|
| Gift tax paid in 1971 | $232,630.09 |
| Less basis in certificates transferred | 8,742.60 |
| Long-term capital gain | 223,887.49 |
| 50% deduction for long-term capital gain | 111,943.75 |
| Increase in taxable income | $111,943.75 |

appreciated property on the condition that the donees pay the gift taxes arising as a result of the transfers (J.A. 3-14, 25-34). Adhering to its prior line of decisions beginning with *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969),[7] the Tax Court upheld petitioners' position that they merely made a net gift[8] of the difference between the fair market value of the transferred property and the gift tax paid by the donees. In those prior cases, the Tax Court had ruled that the donor does not realize taxable income as a result of the transfer in such a situation (Pet. App. A12-A22).

The court of appeals reversed (Pet. App. A1-A11).[9] It "agree[d] with the Commissioner that *Turner* and its progeny were incorrectly decided" (Pet. App. A6). It accordingly ruled that "to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the

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[7] See *Estate of Davis* v. *Commissioner*, 30 T.C.M. (CCH) 1363 (1971), aff'd per curiam, 469 F.2d 694 (5th Cir. 1972); *Hirst* v. *Commissioner*, 63 T.C. 307 (1974), aff'd, 572 F.2d 427 (4th Cir. 1978) (en banc); *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.). See also *Bradford* v. *Commissioner*, 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Krause* v. *Commissioner*, 56 T.C. 1242 (1971); *Estate of Weeden* v. *Commissioner*, 39 T.C.M. (CCH) 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *Benson* v. *Commissioner*, 37 T.C.M. (CCH) 989 (1978), appeal pending, No. 79-1032 (6th Cir.). But cf. *Owen* v. *Commissioner*, 652 F.2d 1271 (6th Cir. 1981), decision vacated, Sept. 11, 1981.

[8] A "net gift" is a shorthand description of a gift made on the condition that the donee pay the gift tax liability of the donor as a result of the transfer. Because this payment is treated as consideration received by the donor, only the excess, or "net," transfer is the amount of the gift. This offset will correspondingly reduce the gift tax due. Accordingly, the tax must be computed by using an algebraic formula. See Rev. Rul. 75-72, 1975-1 Cum. Bull. 310. However, Rev. Rul. 75-72, *supra*, "is concerned only with the gift tax consequences * * * [of a net gift transfer] and not with the income tax consequences thereof" (1975-1 Cum. Bull. at 313).

[9] On appeal, the two cases were consolidated for argument and decision.

property transferred, the donors realized taxable income" (Pet. App. A11). In so holding, the court observed that "when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income" (Pet. App. A10). As the court saw the matter, the Tax Court's characterization of the transaction as a "net gift" does not alter the essential economic fact that the donor is actually transferring the entire property and receiving something in return and that the amount received in return is a benefit that constitutes taxable income to the extent it exceeds the donor's basis in the property. The court therefore cited with approval the dissenting opinion in *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978) (en banc), that "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities" (*id.* at 438).

The court found further support for its ruling in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). Those decisions held that donors of property encumbered by nonrecourse indebtedness received taxable gain to the extent that the indebtedness exceeded their bases in the property. As the court below stated, "[i]t makes no difference whether he [the donor] receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit" (Pet. App. A10).

## SUMMARY OF ARGUMENT

1. Section 61(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that gross income means all income from whatever source derived. Section 1001(a) of the Code provides in particular that the gain from a sale or other disposition of property is the excess of the amount realized therefrom over the transferor's adjusted basis in the property. The amount realized is defined

in Section 1001(b) as the sum of money received plus the fair market value of any other property received.

It is well established that the amount realized under Section 1001 does not mean that the taxpayer must receive cash (or property) in hand. Rather, the concept of amount realized encompasses a measurable economic benefit in any of many forms, including a discharge of personal liability. Thus, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), this Court held that payment of a taxpayer's federal income tax liability by another person is tantamount to actual payment of that amount to the taxpayer and use by him of that money to pay his taxes. Similarly, the discharge of indebtedness on the transfer of property constitutes the receipt of income for purposes of Section 61(a). *Crane* v. *Commissioner*, 331 U.S. 1, 13-14 (1947).

*Old Colony Trust* and *Crane* control this case and require affirmance of the judgment below. In accordance with these principles, the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. In both of these cases, petitioners made a gift of low basis, highly appreciated securities to a member of their family. As a condition of the gift, the donees agreed to pay the donors' federal and state gift taxes incurred as a result of the gift. The gift taxes paid by the donees in each instance exceeded petitioners' bases in the securities transferred (Pet. App. A3). By making the gifts conditional on the donees' payment of the applicable gift taxes, petitioners received a real and substantial economic benefit, because the donees' payment discharged petitioners from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. As the court below observed (Pet. App. A10), the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. Since the

donor would clearly be liable for tax in that case, assuming the amount realized exceeded his basis (cf. Treasury Regulations on Income Tax, § 1.1001-1(c) (26 C.F.R.)), there is no reason for excusing him from income tax on such a transfer merely because a different route leading to the same destination is followed. As this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

Thus, in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir), cert. denied, 419 U.S. 1040 (1974), the court imposed an income tax upon the donor of low basis, highly appreciated stock where, immediately prior to the gift, the donor had pledged the stock as collateral for a loan, the proceeds of which were used in large part to satisfy the donor's gift tax liability on the transfer. Describing the interrelated series of transactions there as equivalent to the donee's payment of the donor's gift tax liability, the court of appeals stated that "[t]he payment of a donor's gift tax liability by the donee constitutes income to the donor" (495 F.2d at 1083). The Second Circuit reached a similar conclusion in *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), where the donor of property encumbered by nonrecourse mortgages in excess of his adjusted basis was held taxable on that excess. Expressing agreement with the decision in *Johnson*, the court in *Levine* stated that "the assumption of another's legal obligation or debt is considered income" (634 F.2d at 16).

2. *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978) (en banc), upon which petitioners rely, were incorrectly decided. The incidence of taxation does not turn on the subjective intent of the donor, as those courts held. Rather, it flows from the economic substance of the transaction. In these so-called net gift transfers, where the donor transfers low basis appreciated property on the condition that the

donee pay the gift tax, the donor realizes a definite amount upon the donee's discharge of the donor's primary liability for payment of the gift tax. If the donor's gift tax liability exceeds his basis in the property transferred, the donor has taxable gain despite the fact that he may not have "intended" to effect a sale or other taxable disposition of the gift property. As this Court observed in *Commissioner* v. *Duberstein*, 363 U.S. 278, 286 (1960), "It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter."

3. A decision in favor of the Commissioner's position should be fully applicable to petitioners in these cases. Petitioners and the amici claim that any decision by this Court in favor of the Commissioner should be prospective only on grounds of *stare decisis* and their purported reliance on the Sixth Circuit's decision in *Turner*. But, as the court of appeals correctly stated, a taxpayer residing in one circuit may not avoid a tax otherwise due by claiming reliance upon a decision of another court of appeals. Indeed, even reliance upon a decision of the court of appeals in the taxpayer's home circuit will not relieve him from taxation if the rule announced there is ultimately rejected by this Court. See *C. Blake McDowell, Inc.* v. *Commissioner*, 652 F.2d 606 (6th Cir. 1980). Thus, in *United States* v. *Estate of Donnelly*, 397 U.S. 286 (1970), this Court's decision upholding the validity of a federal tax lien was applied even though the prevailing interpretation of the tax lien statute at issue in the taxpayer's home circuit would have invalidated the lien.

In making their net gift transfers, petitioners therefore simply ran the risk that the rule of law announced in *Turner* would not ultimately survive. As this Court held in *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971), judicial decisions should be applied to all pending cases unless a "new principle of law" established would be aided by prospective application only and nonretroactive treatment would avoid "substantial inequitable results." Given the

Commissioner's consistent position over the past 25 years as to the income tax consequences of net gift transfers, taxing petitioners on the gain they realized in these transactions in 1972 does not produce "substantial inequitable results."

## ARGUMENT

### A DONOR'S TRANSFER OF PROPERTY SUBJECT TO THE CONDITION THAT THE DONEE PAY THE DONOR'S GIFT TAX LIABILITY RESULTS IN TAXABLE GAIN TO THE DONOR TO THE EXTENT THAT THE GIFT TAXES PAID BY THE DONEE EXCEED THE DONOR'S BASIS IN THE PROPERTY

#### A. A person realizes taxable gain when another party pays his indebtedness or discharges his liability

1. This case presents an important question on which the courts of appeals have divided concerning the income tax consequences to the donor upon the gift of appreciated property, where the gift is made on the condition that the donee pay the donor's gift tax liability imposed upon the transfer, and the gift taxes exceed the donor's basis in the property. Unlike the ordinary gift, the type of transaction at issue here involves consideration flowing in both directions between the donor and donee. First, the appreciated property is transferred from donor to donee; second, in exchange for, and on condition of, the gift, the donee pays the donor's gift tax liability that arises as a result of the transfer. It is the latter aspect of the transaction—the donee's payment of the gift tax liability—that is the focus of the Commissioner of Internal Revenue's determination and the court of appeals' decision that the donor has realized taxable gain to the extent that the gift tax exceeds the basis in the property.

An example will help to illustrate the problem posed by the transactions in this case. Suppose A has stock worth $1 million with a basis of $1,000. He transfers it to his son B on the condition that B pay the gift tax liability of $200,000 that is imposed upon A as a conse-

quence of the transfer. In accordance with his promise, B pays $200,000 to the Internal Revenue Service that would otherwise be payable by A. Properly analyzed, A has "received" $200,000 from B's discharge of his gift tax liability and that discharge was made in exchange for the transfer. There can be no doubt that the gift tax obligation belongs to the donor A. Section 2502(d) of the Internal Revenue Code provides that "The tax imposed by section 2501 [the gift tax] shall be paid by the donor." Thus, if B undertakes to discharge A's gift tax liability, B's payment of A's obligation is income to A.

The fact that A never received the money in hand is of no consequence for purposes of the tax law. A is deemed to have received the $200,000 because that amount was used to discharge his indebtedness, and such a measurable economic benefit constitutes gross income. In this respect, the transaction is similar to an employer's paying his employee's grocery or utility bills. Such amounts are taxable compensation despite the fact that the money goes directly from the employer to the grocer or utility company. It is the discharge of the employee's liability that constitutes gross income. As this Court held more than 50 years ago in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929), an employer's payment of his employee's income tax represents gross income to the employee. "The form of the payment is expressly declared to make no difference. * * * It is therefore immaterial that the taxes were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed" (*ibid.*). Indeed, if the rule were otherwise, different tax consequences would turn on the empty formalism of whether B transferred the money to A for payment to the tax collector, or whether B paid it directly to the tax collector. Accord: *Douglas* v. *Willcuts*, 296 U.S. 1 (1935); *Wall* v. *United States*, 164 F.2d 462, 464 (4th Cir. 1947). See also Section 61(a)(12) of the Code

(gross income includes "Income from discharge of indebtedness").

Returning to our example, it is therefore clear that A, who stands in the place of petitioners in these cases, is properly chargeable with income equal to the amount of his gift tax indebtedness discharged by B. But what is the character of the income that A has received? Suppose, as in *Old Colony Trust Co.*, A's employer, or someone other than the donee B, has undertaken to pay A's gift tax obligation. Putting aside the possibility that the payments were a gift to A, there could be little doubt in such circumstances that A would be deemed to have received $200,000 in additional income taxable at ordinary rates. If the person discharging A's gift tax liability were A's employer, that additional ordinary income would have doubtless fit within the statutory rubric "Compensation for services, including fees, commissions, and similar items" (Section 61(a)(1)). Here, however, B's discharge of A's gift tax liability is an integral component of the transaction in which A has transferred the appreciated stock to B. Since A has made the gift on the condition that B pay his gift taxes, B's discharge of A's obligation is, in contractual and economic terms, consideration in exchange for the transfer.

When these factors are put in statutory terms, it becomes clear that the $200,000 paid by B to the tax collector on behalf of A is an "amount realized" by A upon his transfer of the stock to B. Section 61(a) of the Code provides that gross income "means all income from whatever source derived * * *," including "Gains derived from dealings in property * * *" (Section 61(a)(3)). Section 1001(a) provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized * * * over the adjusted basis * * * [of the property]." The term "amount realized" is defined by Section 1001(b) as "the sum of any money received plus the fair market value of the property (other than money) received."

Here, A has received $200,000 upon the disposition of stock with a basis of $1,000. Hence, the proper computation of his taxable gain is $200,000—the amount realized—less his $1,000 basis, or $199,000. Since the transaction involved A's transfer of the stock in "exchange" for B's payment of A's gift tax liability, A's taxable gain is subject to the preferential capital gains rates available for sales and exchanges of capital assets. See Sections 1201, 1221, 1222 of the Code.[10]

Finally, petitioners claim (Br. 17, 20-25) that they did not realize taxable gain as a result of their net gift transfers because the transfers did not constitute a "sale or exchange." But Section 1001(a) of the Code provides for the taxation of "gain from the sale *or other disposition* of property" (emphasis supplied). It is settled that gifts constitute "dispositions" for tax purposes, and thus may result in taxable gain. See, *e.g.*, *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), aff'g 72 T.C. 780 (1979); *Guest* v. *Commissioner*, 77 T.C. 9 (1981). In the case of a simple (rather than net) gift, no amount is realized because the donor receives nothing. But where, as here, the donor realizes, by virtue of the discharge of his resulting gift tax liability, an amount in excess of his basis of the property transferred, taxable gain is the result. Indeed, the logical consequence of petitioners' argument that there was no sale or other disposition would require taxation of the full amount of the payment as ordinary income from the discharge of indebtedness, without any offset for basis. See Section 61(a)(12) of the Code. Compare Section 108 of the Code (exception for insolvent taxpayers).

2. The decisions of this Court support the foregoing analysis of the transaction at issue in this case. Just as *Old Colony Trust Co.* established that an employer's pay-

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[10] In economic terms, the example is equivalent to A's sale of the stock to B for $200,000. Since the stock is worth $1 million, A has made a gift to B of $800,000. And in these circumstances, A would be required to recognize taxable gain of $199,000—$200,000 less his basis of $1,000.

ment of the tax liability of his employee gave rise to taxable income to the employee, there is analogous precedent holding that the discharge of any type of indebtedness in connection with the disposition of property constitutes taxable income to the party who is relieved of indebtedness. As the Court observed in *Helvering* v. *Bruun*, 309 U.S. 461, 469 (1940), "[T]he realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."

Indeed, the Court subsequently made clear in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), that the discharge of indebtedness rule was fully applicable with respect to a mortgage obligation. There, the taxpayer sold property subject to an outstanding nonrecourse mortgage, for cash plus the buyer's assumption of the mortgage. The Court held that: (1) the face amount of the mortgage was properly includable in the taxpayer's basis in the property; and (2) the amount realized upon the sale included not only the cash tendered by the buyer but also the face amount of the nonrecourse mortgage assumed by the buyer.

It is the second aspect of the *Crane* holding that is instructive in resolving the issue presented in the instant cases. In *Crane*, the buyer's assumption of the mortgage constituted a discharge of the seller's indebtedness that had to be taken into account in computing the "amount realized" by the taxpayer upon the sale. For a solvent taxpayer like Mrs. Crane or petitioners in these cases, a discharge of indebtedness represents a measurable economic benefit that is includable in gross income. As the Court explained, "We are * * * concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real

and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another" (331 U.S. at 14).[11]

3. In our view, the principles established by this Court in *Old Colony Trust Co.* and *Crane* control this case and require affirmance of the judgment below. There, as here, the taxpayer's indebtedness or liability was paid by another party. As was the case in *Old Colony Trust Co.*, petitioners' liability was for taxes imposed upon them as a personal obligation.[12] And, as in *Crane*, the obligation was discharged in consideration for the transfer of property. *Old Colony Trust Co.* teaches that the payment of the tax liability of another constitutes taxable income to the relieved taxpayer. The refinement

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[11] The lower courts have applied the *Crane* principle in a variety of factual contexts in which appreciated property is transferred and a mortgage debt secured by the property is discharged. See, *e.g.*, *Simon* v. *Commissioner*, 32 T.C. 935 (1959), aff'd, 285 F.2d 422 (3d Cir. 1960); *First National Industries, Inc.* v. *Commissioner*, 26 T.C.M. (CCH) 608 (1967), aff'd, 404 F.2d 1182 (6th Cir. 1968), cert. denied, 394 U.S. 1014 (1969); *Malone* v. *United States*, 326 F. Supp. 106 (N.D. Miss. 1971), aff'd per curiam, 455 F.2d 502 (5th Cir. 1972).

[12] *Wall* v. *United States*, *supra*, 164 F.2d at 464. Indeed, petitioners appear to agree with this proposition for elsewhere in their brief (at 6, 26) they acknowledge that "[l]egally and economically, the donor has paid the gift taxes." If the gift tax is not paid when due, a ten-year lien is placed on the gift property, and the donee becomes secondarily liable for the tax to the extent of the value of the gift. 26 U.S.C. 6324(b). The donee's liability under that section, however, is secondary and not coextensive with the donor's primary liability. Pursuant to that primary liability, the donor's assets would be subject to collection. efforts by the Service, just as would be the case with respect to any other type of tax. See *Estate of Sheaffer* v. *Commissioner*, 37 T.C. 99, 105 (1961), aff'd, 313 F.2d 738 (8th Cir. 1963), cert. denied, 375 U.S. 818 (1963). It therefore cannot be said that "Congress did not care who paid the gift tax," as one of the amici (Cleaver Br. 18) asserts. Just as the income tax is a liability of the recipient of income, though a transferee may be secondarily liable (see Section 6901 of the Code), here, too, the gift tax is a statutory liability of the donor.

added by *Crane* is that the discharge of indebtedness in connection with the transfer of property is includable in the amount realized by the transferor for purposes of computing taxable gain.

Both the *Old Colony Trust Co.* principle and the *Crane* application of that principle in the context of discharge of indebtedness upon the transfer of property require petitioners to recognize taxable gain to the extent that the gift tax paid by the donees exceeded petitioners' adjusted bases in the property transferred. In *Old Colony Trust Co.*, the Court cited four factors in support of its holding that an employer's payment of his employee's income tax liability constituted income to the employee. These were: (1) the tax liability was imposed upon the employee; (2) the taxes were actually paid by the employer; (3) the employer's payment of his employee's taxes was made pursuant to an express agreement; and (4) the "taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as part of the compensation therefor" (279 U.S. at 729).

The factors that the Court regarded as dispositive in *Old Colony Trust Co.* are likewise present in the instant cases. Here, the gift tax liability was statutorily imposed upon petitioners, the taxes were actually paid by the donees, the payment was made in accordance with an express agreement, and the donees paid the taxes "upon a valuable consideration," namely, the receipt of the gift. Indeed, the fact that petitioners made the gifts in these cases on the condition that the donees pay their gift tax liabilities negates any inference that the donees' payments represented tax-free gifts back to petitioners. The quid pro quo nature of the transaction establishes that the donees' payments of the gift taxes were not transfers motivated by the donees' "detached and disinterested generosity"—the hallmark of a tax-free gift. *Commissioner* v. *Duberstein*, 363 U.S. 278, 285 (1960); *Commissioner* v. *LoBue*, 351 U.S. 243, 246 (1956). Accord: Rev. Rul. 75-72, 1975-1 Cum. Bull. 310, 311.

Contrary to petitioners' (Br. 18, 24, 26) and the amicus Owen's (Br. 8, 13) arguments, this Court's decision in *Old Colony Trust Co.* cannot be confined to the case in which an employer pays the income taxes of his employee as part of the employee's compensation. To be sure, the "valuable consideration" upon which the taxes were paid in *Old Colony Trust Co.* was the services performed by the employee. But nothing in the Court's opinion suggests that compensation for services is the only type of consideration that will support the conclusion that the discharge of another person's tax liability constitutes income to the relieved taxpayer. The critical fact, as the Court pointed out, is that the taxes must be paid in exchange for the taxpayer's performance of some valuable consideration in order to negate any inference that the payment of the tax was a gift (see 279 U.S. at 730). Here, the valuable consideration was petitioners' transfers of the appreciated property. "It is therefore immaterial that the taxes were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed" (*id.* at 729).

4. In accordance with these principles, we submit that the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. By making the gifts conditional upon the donee's payment of the applicable gift taxes, petitioners have received a real and substantial economic benefit because the donees' payments discharged them from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. The court below therefore properly observed (Pet. App. A10) that the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. There is no reason for excusing the donor from income tax on a net gift transfer merely because a different route leading to the same destination is followed. As

this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

**B. The donees' discharge of petitioners' gift tax liability resulted in petitioners' receipt of a measurable economic benefit that must be included in gross income**

1. Once it is recognized that "[t]he form of the payment is expressly declared to make no difference" so that "[i]t is therefore immaterial that the taxes were directly paid over to the Government" (*Old Colony Trust Co.* v. *Commissioner*, *supra*, 279 U.S. at 729), it becomes clear that the critical fact in these cases is petitioners' receipt of a measurable economic benefit in the form of the discharge of their gift tax liabilities. As we have pointed out (*supra*, pages 12-13), the fact that petitioners did not actually receive the money is of no consequence. *Old Colony Trust Co.* teaches that for income tax purposes, the donees' discharge of petitioners' gift tax liability is equivalent to the donees' payment of the amount of the gift tax directly to petitioners themselves, who in turn are deemed to have paid it over to the government.

In these circumstances, the court of appeals correctly concluded that petitioners' net gift transactions are comparable to any transfer of appreciated property where the transferee assumes mortgage encumbrances in excess of the transferor's basis in the property. Put in terms of our previous example (*supra*, page 11-12), suppose A has stock worth $1 million with a basis of $1,000, and the stock is pledged to secure a nonrecourse loan of $200,000. If A thereafter transfers the stock to B, who assumes payment of the loan, A will have taxable gain of $199,000 ($200,000 less $1,000). Under the *Crane* principle, B's assumption of the debt secured by the property is income to A, to the extent that the amount of the debt exceeds the transferor's basis in the property.

In some respects, A's physical receipt of the $200,000 proceeds of the loan to use as he sees fit and B's assump-

tion of it may be viewed as presenting a more graphic case than the facts of the original example for charging A with $199,000 of taxable gain. But the principle applied in both the original example and in the variation on it is precisely the same, *viz.*, the rule of *Old Colony Trust Co.* and *Crane* that the payment or assumption of a debt by another constitutes gross income to the relieved debtor. In the original example, B paid A's $200,000 gift tax obligation; here, B paid A's mortgage indebtedness. In both cases, A has received a measurable economic benefit that must be included in his gross income.

2. Given the close similarity between a net gift and the mortgage assumption variation on the transaction, the court of appeals correctly concluded that the Commissioner's determination in these cases here was supported by the analyses set forth in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). In *Johnson*, the taxpayer transferred stock with a basis of $10,000 and a fair market value of $500,000 to three separate trusts established for the benefit of his children. A few days prior to the transfer, however, the taxpayer had pledged the stock as collateral for a nonrecourse loan of $200,000. About a month after the transfer, the trustees cancelled the taxpayer's $200,000 note, substituting their own note for a like amount. When the transactions were completed, therefore, the taxpayer had $200,000 in cash and the trust had stock worth more than $500,000, encumbered by a $200,000 note. The taxpayer then used $150,000 of the loan proceeds to satisfy his gift tax liability arising from the transaction, and retained the $50,000 balance. The taxpayer conceded that he had realized $50,000 in income on the transaction, but he maintained that he did not realize any additional income when $150,000 of the loan proceeds were used to pay his gift tax liability.

On these facts, the court held that the taxpayer had received something of value upon transferring his en-

cumbered stock to the trust, and that the full amount of the loan assumed by the trustees constituted income to him in the year of receipt under Section 61 of the Code, as income from whatever source derived, and specifically under Section 1001 of the Code as gain from the disposition of property (495 F.2d at 1083-1084). The court noted that this would be the case whether the transfer were viewed as the discharge of the taxpayer's gift tax liability under *Old Colony Trust Co.*, or as the discharge of a debt under *Crane*. Under either analysis, the taxpayer is considered to have realized income (495 F.2d at 1084). As the court stated (*id.* at 1083): "The payment of a donor's gift tax liability by the donee constitutes income to the donor." In the court's view, it did not matter whether the gift taxes were paid through a loan placed on the property just prior to a gift of the encumbered property, or whether the gift taxes were paid directly by the donees as a condition to receiving the gift, as in the instant case. In both instances, the taxpayer raised the funds necessary to pay his gift tax liability out of the donated property itself, thereby obviating the necessity of using his personal funds for that purpose. Characterizing the transaction as a "net gift," as the taxpayer in *Johnson* urged, has no bearing on the income tax consequences arising on the transfer. As the court stated, "This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash" (*id.* at 1084).

*Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), is to the same effect. There, the taxpayer transferred property encumbered by a nonrecourse mortgage to a trust established for the benefit of his grandchildren. The trust accepted the property subject to the mortgage, and agreed further to pay certain expenses associated with the property for which the taxpayer was personally liable. At the time of the transfer,

the mortgage obligation plus the unpaid expenses exceeded the taxpayer's adjusted basis in the property. Following the principles established in *Crane* [13] and *Old Colony Trust Co.*, the court of appeals concluded that the taxpayer had realized taxable income to the extent the mortgage and expenses assumed by the trust exceeded his adjusted basis in the transferred property. Describing the transaction as other than a " 'pure' gift" (634 F.2d at 16), Judge Friendly pointed out in *Estate of Levine* that the taxpayer there had received valuable consideration for the gift, at least to the extent that his personal liability of $124,573.58 in unpaid expenses was discharged as a result of the transfer.[14] As the court viewed the matter, such a property transfer should be treated as though "the donee had paid * * * [that $124,573.58] sum directly to Levine [the donor-taxpayer]" (*ibid.*).

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[13] Contrary to the petitioners' (Br. 19-20) and the amicus Owen's arguments (Br. 18-19), the government has never conceded that the principles established in *Crane* were inapplicable to net gift transfers. In our brief on appeal in the court of appeals in *Johnson*, and in our Memorandum in Opposition filed in this Court (Oct. Term, 1974—No. 74-176), we noted the factual distinction in the cases between mortgaging property for the purpose of paying the gift taxes and then transferring the encumbered property, on the one hand, and making a gift of unencumbered property conditioned on the donee's payment of the gift tax liability, on the other. In the course of that discussion, we noted (Memorandum at 4) that in *Johnson* the taxpayer's "actual receipt of cash with no personal liability to repay it graphically illustrates the point" that his use of the cash from the loan proceeds to pay the gift tax liability was an "amount realized" under Section 1001(a). But as we further stated (*ibid.*), the distinction nevertheless "should not warrant a difference in tax treatment. In both cases, the amount of the gift tax is an 'amount realized' under Section 1001(a)."

[14] Under the rule of *Crane*, we submit that the transfer of property encumbered by any debt, recourse or nonrecourse, results in taxable income to the donor to the extent the liabilities discharged exceed the taxpayer's adjusted basis in the property transferred. See *Estate of Levine* v. *Commissioner*, *supra*, 72 T.C. at 792. But cf. *Tufts* v. *Commissioner*, 651 F.2d 1058 (5th Cir. 1981), rev'g 70 T.C. 756 (1978).

Both Dr. Johnson and Mr. Levine in the foregoing cases unquestionably received a measurable economic benefit upon their transfers of their appreciated property to the trusts. "Dr. Johnson received $200,000, free and clear of any obligation to repay that amount from any property in his possession. This amount constituted gross income in the year of receipt, under the broad definition set forth in section 61 of the Code—'all income from whatever source derived.' It makes no difference to what use the $200,000 was put, whether to pay for food or to pay a gift tax" (495 F.2d at 1083). Similarly, in *Levine*, "The donee assumed not only the $785,908.34 in mortgages and accrued interest for which Levine was not personally liable but also the $124,573.58 of 1969 expenses, not constituting a lien, for which he was" (634 F.2d at 16). As Judge Friendly there observed (*ibid.*), "If the donee had paid the latter sum directly to Levine, this case would clearly be governed by *Crane* since the donor would have received 'boot.' However, the assumption of another's legal obligation or debt is considered income under *Old Colony Trust Co.* * * *. We can thus see no sound reason for reaching a result differing from that in *Crane* on the facts of this case" (footnote omitted).

Since the donee's assumption of the donor's obligation is analytically equivalent to the donee's direct payment of cash in that amount to the donor, the reasoning of *Johnson* and *Estate of Levine* bears heavily on the transactions at issue here and effectively refutes petitioners' claim that a net gift yields no income tax consequences to the donor. For if the donees in the instant cases had paid the amount of the gift tax directly to petitioners, there would be no doubt that such amounts would have constituted gross income to petitioners in the year of receipt. Their payment of petitioners' gift tax obligations to the Internal Revenue Service is no less a measurable economic benefit that is includable in petitioners' gross income.

*Johnson* and *Estate of Levine* necessarily question the correctness of the two principal appellate authorities deal-

ing with net gifts upon which petitioners rely, *viz.*, *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 63 T.C. 307, aff'd 572 F.2d 427 (4th Cir. 1978). Those decisions, to which we now turn, are premised principally on the erroneous assumption that the donor's intent to make a net gift precludes imposition of tax on the gain arising from the transfer to the extent that the gift tax paid by the donee exceeds the donor's basis in the property. In our view, the donor's intention has no bearing upon the objective economic reality and the income tax consequences of these transactions.

**C. The donor's intent to make a net gift does not preclude imposition of income tax on the gain arising from the transfer**

1. Petitioners do not challenge the correctness of the foregoing analyses of *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir. 1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). Rather, they argue (Br. 24-25) that those cases are distinguishable because "[a] net gift was not involved; a sale was involved" (Br. 24). Petitioners accordingly assert that they received no economic benefit upon their transfers because they simply intended to make a net gift and "[a] net gift is not a sale" (Br. 25).

But these *ipse dixits* that cast "sales" and "gifts" as two mutually exclusive categories that become applicable at the choice of the transferor are no more instructive than the "part sale and part gift" nomenclature that has been elsewhere employed to describe such transfers. See, *e.g.*, *Turner* v. *Commissioner*, *supra*. As the Sixth Circuit subsequently observed in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1084, "This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash."

Moreover, characterizing the transaction as a "net gift" has no relevance to the income tax consequences of the transfer. As we have pointed out (*supra*, page 6, and note 8), the term "net gift" has meaning only for gift tax purposes. The donee's promise to pay the donor's tax necessarily reduces the value of the gift upon which the gift tax is imposed. Since the gift tax and the value of the gift are two dependent variables, the Service uses an algebraic formula to compute them. See Rev. Rul. 75-72, *supra*. But the formula "is concerned only with the gift tax consequences * * * [of a net gift transfer] and not with the income tax consequences thereof" (1975-1 Cum. Bull. at 313).

At all events, the fact that petitioners claim to have intended their transfers to be net gifts does not insulate them from income tax upon the gain arising from the transfers. As this Court pointed out in *Commissioner* v. *Duberstein*, 363 U.S. 278, 286 (1960), "the donor's characterization of his action is not determinative * * *. It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Hence, petitioners' subjective intent should not determine the income tax consequences of their actions in making a net gift. Given a choice, most taxpayers would claim to have intended to follow a course that would produce the least tax liability. Intent is therefore an unreliable indicium in such cases. Accordingly, if, as we submit, a net gift transfer confers a real and substantial benefit upon the donor in the form of the donee's discharge of the gift tax liability, that payment is an "amount realized" on the transfer that should result in taxable gain to the donor to the extent it exceeds his basis in the property, regardless of his intent. As the Sixth Circuit put the matter in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1083 n.6: "[I]t is difficult to find that the parties here actually intended a part sale, part gift, in view of the obvious tax implications of such an intention. It is better to apply

the Tax Code equitably to basically similar transactions than to impose different results depending upon a hindsight determination of 'actual intent.' "

2. *Turner* v. *Commissioner*, 49 T.C. 356, aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978), upon which petitioners rely, are therefore erroneous because they principally turn on the donor's intention to make a net gift.[15]

a. In *Turner*, the taxpayer made nine separate transfers of low-basis securities to three individuals outright and to six others in trust. All of the transfers were conditioned on the payment by each transferee of the gift taxes imposed upon the taxpayer-donor. The funds used to pay the gift taxes were raised by a sale of some of the transferred stock, through family loans, by utilizing income earned from the trust, and by use of available cash. The Commissioner, in seeking to impose long-term capital gain upon the donor, argued that at least with respect to the individual donees, the transfers should be treated as part sales and part gifts, with the result that the taxpayer realized taxable gain on the transfers to the extent that the gift taxes paid by the donees on her behalf exceeded her adjusted basis in the stock transferred.

The Tax Court upheld the taxpayer's position that she had no taxable gain on the transfer. In so ruling, the court felt that the case turned on a choice between the net gift characterization urged by the taxpayer and the part gift, part sale nomenclature advanced by the Commissioner. Given the intra-family nature of the transfer, the Tax Court concluded that "what was intended by [the taxpayer] was a net gift, the value of the shares less the value of the gift tax payable on the transfers"

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[15] *Humacid Co.* v. *Commissioner*, 42 T.C. 894 (1964), upon which petitioners also rely (Br. 8), is distinguishable. There, the court held that a donor did not realize income when he made a gift of appreciated property. The case did not involve a gift of appreciated property made on the condition that the donee pay the resulting gift taxes.

(49 T.C. at 363). The court of appeals affirmed per curiam (410 F.2d 752 (6th Cir. 1969)).[16]

But, as we have pointed out (*supra*, pages 25-26), the income tax consequences of these transactions do not turn upon the subjective intent of the donor that he intended to make a gift, or a net gift, as opposed to a sale. The Service's published ruling (*supra*, page 6, note 8) makes clear that the term "net gift" is relevant only for purposes of computing the amount of gift tax due on such a transfer made on the condition that the donee pay the gift tax. For income tax purposes, however, the donee's discharge of the donor's gift tax obligation as a condition of the transfer is consideration that constitutes gross income under Section 61 and an "amount realized" under Section 1001(a) of the Code.[17] Thus, to the extent that the gift

[16] Petitioners (Br. 17, 29) and the amici (Owen Br. 4, 19, 22; Cleaver Br. 33, 41) claim that the Fifth Circuit would follow *Turner* in a net gift case. We submit, however, that the Fifth Circuit's position on this matter is not clear. Compare *Estate of Davis* v. *Commissioner*, 469 F.2d 694 (5th Cir. 1972), aff'g per curiam 30 T.C.M. (CCH) 1363 (1971), with *Malone* v. *United States*, 455 F.2d 502 (5th Cir. 1972), aff'g per curiam 326 F. Supp. 106 (N.D. Miss. 1971).

[17] The Tax Court in *Turner* appears to have been misled by the Commissioner's concession in that case that the transfers in trust (as opposed to those made directly to individuals) did not result in taxable gain to the donor. The Commissioner's concession was apparently prompted by the fact that the trustees were not personally liable for payment of the gift taxes imposed on the transfers (49 T.C. at 362-363). But this concession—which we believe to have been ill-advised and which was disavowed by the Commissioner in subsequent litigation—would have required the Tax Court to characterize similar transfers differently for tax purposes. It was not unreasonable for the court to have declined to do so. The court of appeals likewise attributed significance to the Commissioner's concession (410 F. 2d at 753). Subsequently, in *Johnson*, the Sixth Circuit characterized *Turner* as having "no precedential value beyond its peculiar fact situation" because of the Commissioner's concession in that case (see 495 F. 2d at 1086). The court below similarly confined *Turner* by citing the Sixth Circuit's subsequent characterization of it with approval (Pet. App. A7).

tax exceeds the donor's basis in the property, the donor must recognize gain.[18]

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[18] In rejecting the Commissioner's position in *Turner*, the Tax Court relied on a series of prior cases presenting the issue whether the donor had retained an income interest in trusts he established and which were funded by property transferred by him. In each of these "retained interest" cases (see Pet. App. A5-A6), the Commissioner, invoking the grantor trust provisions of Sections 671-677 of the Code, sought to tax the donor-settlor at ordinary income rates to the extent that trust income was used to satisfy the donor's gift tax liability. The Commissioner prevailed in several of the earlier cases (*e.g.*, *Estate of Staley* v. *Commissioner*, 47 B.T.A. 260 (1942), aff'd, 136 F.2d 368 (5th Cir. 1943); *Estate of Sheaffer* v. *Commissioner*, 37 T.C. 99 (1961), aff'd, 313 F.2d 738 (8th Cir. 1963), cert. denied, 375 U.S. 818 (1963) (*Sheaffer I*)), because the donor specifically conditioned the transfer of property to the trust he created upon the trust's use of trust income to pay his gift tax liability, either by payment to him directly (as in *Estate of Staley*), or by use of a loan which was required by the trust instrument and repaid from future trust income (as in *Sheaffer I*). Subsequent donors easily circumvented the grantor trust provisions, however, by structuring the transaction to give the trustee discretion to use any funds at its disposal for payment of the gift taxes. See, *e.g.*, *Estate of Morgan* v. *Commissioner*, 37 T.C. 981 (1962), aff'd, 316 F.2d 238 (6th Cir. 1963), cert. denied, 375 U.S. 825 (1963); *Estate of Sheaffer* v. *Commissioner*, 25 T.C.M. (CCH) 646 (1966) (*Sheaffer II*). For even if the gift taxes were, in fact, paid through a loan secured by the trust property, and future trust income was used to make the loan repayments (as in *Sheaffer I*), income could not be taxed to the donor under Section 677 if the trustee was given broad discretion to determine the method of paying the gift tax liability. *Estate of Morgan, supra; Sheaffer II, supra.* At all events, the donor's liability under Section 677 was limited to the income earned by the trust prior to the payment of the donor's gift tax liability. *Krause* v. *Commissioner*, 56 T.C. 1242 (1971).

In all of the retained interest cases, the decisions turned on the power granted to the trustee over the use of the trust income. If that power was too narrowly drawn, and trust income was paid to the donor or used to satisfy the donor's gift tax liability, the donor was subject to taxation as a beneficiary of the trust at ordinary income rates. But the instant cases do not involve taxation of trust income to petitioners under Section 677. Rather, the Commissioner seeks here to tax the gain represented by the dif-

Moreover, even on the assumption that the Tax Court in *Turner* correctly determined that the taxpayer there actually transferred only her net gift, as opposed to the entire property, she nevertheless should have been liable for the deficiency determined by the Commissioner. If the taxpayer in *Turner*, or, for that matter, petitioners here, are viewed as having satisfied their gift tax liability with a hypothetical "retained interest" [19] in the transferred property, the necessary consequence of such a theory is that they used appreciated property to satisfy their gift tax obligation.[20] In such circumstances, it is settled that the taxpayer must recognize gain to the extent the amount of the obligation discharged exceeded the taxpayer's adjusted basis in the "retained" property. *Danenberg* v. *Commissioner*, 73 T.C. 370, 380-381 (1979); *Bialock* v. *Commissioner*, 35 T.C. 649, 660 (1961); *Peninsula Properties Co.* v. *Commissioner*, 47 B.T.A. 84, 91 (1942). See

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ference between the gift tax paid and the donor's basis in the transferred property. Accordingly, the cases involving ordinary income taxation of trust income under Section 677 have no application here (see *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1085).

[19] Indeed, the retained interest approach proposed by petitioners arguably results in a greater deficiency than the Commissioner has determined. If the donor is deemed to have "retained" some of the property, it may be necessary to allocate petitioners' adjusted bases in the property proportionately between the retained interest and the portion transferred as a net gift. Such an allocation would increase their gain, because a lesser basis would be subtracted from the gift taxes paid in the determination of gain. Here, however, the Commissioner used petitioners' basis in the entire property as an offset against the gift tax to compute their taxable gain. The taxable gain determined by the Commissioner is correspondingly less than under petitioners' retained interest approach.

[20] While the retained interest approach may have relevance to transfers in trust where trust income is actually reserved for the benefit of the donor, it is inappropriate in circumstances where the gift tax liability may be satisfied from any assets of the donee. Even where the corpus of a trust may be used to satisfy this liability, Section 677 has no application because it only taxes trust income to the grantor.

also *United States* v. *Davis*, 370 U.S. 65 (1962) (husband's transfer of appreciated stock to wife in exchange for release of wife's marital claims is a taxable event).[21]

Nor does petitioners' attempted recharacterization of the transaction yield a different result. As they see the matter (Br. 6), "In the net gift, the donor places at the disposal of the donee properties sufficient to pay the gift taxes and secures from the donee an agreement to make the required payment. The donee is a conduit of the donor in making the tax payment and in doing so he is acting for the account of the donor." But the logical consequence of such an analysis would require attribution of the donee's gain on the sale of part of the property to pay the gift tax to the donor. This would be the case whether or not there is an actual sale of the property because the donor has transferred the property for the very purpose of paying the gift tax obligation. If, as petitioners concede, the donee is a "conduit" with respect to part of the property, his payment of the gift tax is equivalent to the donor's sale of that portion of property the sale of which would yield enough proceeds to meet the gift tax liability. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 and n.4 (1945). In sum the net gift transaction cannot be recast in a manner that obscures the essential fact that the donor receives a real and substantial economic benefit from the donee's discharge of the gift tax obligation.[22]

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[21] In *Krause* v. *Commissioner*, *supra*, 56 T.C. at 1248, the Tax Court stated that if a donor had transferred cash in the amount of the gift tax instead of property, the use of the cash for the discharge of the gift tax liability would not have generated any taxable income. This is true enough (see Pet. Br. 26), but the donor's transfer of cash is tantamount to his paying the gift tax himself. Here, on the other hand, the donors transferred the property, and the donees promised to pay the gift tax from any source they deemed appropriate. The Tax Court's observation, as well as petitioners' various economic analyses (Br. 9-11), have no bearing on this case.

[22] In *Evangelista* v. *Commissioner*, 629 F.2d 1218, 1221 n.9 (7th Cir. 1980), aff'g 71 T.C. 1057 (1979), the court of appeals stated that under the Commissioner's net gift theory, a transfer conditioned on the donee's satisfaction of the donor's gift tax liability

The final ground upon which the Tax Court in *Turner* rested its decision is likewise unpersuasive. Contrary to the concerns expressed by the court in that case (49 T.C. at 363-364), and by the amicus Cleaver (Br. 21-22), the Commissioner's position requiring the donor to recognize gain does not result in an improper doubling of the basis computation for the property received by the donee. While the basis of the transferred property in the hands of the donee is not an issue presented for decision in these cases, § 1.1015-4 of the Treasury Regulations provides that the donee's basis is the greater of the amount paid by him for the property, or the donor's basis at the time of the transfer, and the amount of the gift tax paid (see App., *infra*, 9a). Here, the donee's basis is equal to the amount paid for the property (the discharge of the gift tax liability) plus the amount of the gift tax paid.

But there is actually no "double credit" involved. As the Sixth Circuit correctly explained in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1085, the first upward adjustment in the donee's basis (for the amount paid) is necessary because the donor recognizes gain in that amount and that gain should not be taxed again.

> The * * * increase in the donee's basis which is attributable to gift taxes paid by the donor is independently proper. Its function, separate from that of the other * * * increase, is not to discourage gifts. Were basis not raised by the amount of gift taxes paid, a donor would recognize that a shift of resources to the donees would incur a tax without a corresponding adjustment in basis for the donees.

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would give rise to a tax *loss* if the gift taxes paid by the donee were less than the donor's basis in the property transferred. But while a loss might be realized in such an event, not every loss is deductible for income tax purposes. See, *e.g.*, Sections 267(a)(1) and 165(c) of the Code. See also § 1.1001-1(e)(1) of the Treasury Regulations on Income Tax (26 C.F.R.).

> Thus, Congress has authorized increases in a donee's basis both by amounts of gain recognized upon transfers to trusts and by amounts of gift taxes paid, regardless of the fact that such amounts may superficially appear redundant. See section 1015(b), (d); § 1.1015-2, -4, -5, Income Tax Regs.

*Id.* at 1085-1086; footnote omitted.

b. The en banc decision of the Fourth Circuit in *Hirst*, upon which petitioners rely (Br. 12-15, 27, 29), is likewise erroneous. In *Hirst*, the donor transferred three tracts of undeveloped land to her son and family. The transfers were conditioned on the donees' payment of the applicable federal and state gift taxes. The gift taxes paid by the donees ($85,469.55) exceeded the donor's $8,377 basis in the property transferred. The Commissioner thereafter determined that the $77,092.55 spread between those two amounts represented taxable gain to the donor (63 T.C. at 309-310). After reviewing the "tortuous course of decision" on the question, which it described as "characterized by subleties and fine distinctions" (*id.* at 310), the Tax Court ruled that its earlier decision in *Turner* was controlling.[23] Although the court

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[23] The Tax Court did not consider the Sixth Circuit's decision in *Johnson* as a "clear-cut overruling" of *Turner* (63 T.C. at 314-315). Pointing to the fact that the Commissioner's concession in *Turner* applied only to the transfers in trust, the Tax Court concluded that the court of appeals in *Johnson* "was mistaken in its assumption that the Commissioner's concessions in *Turner* deprived it of any precedential value beyond it own facts" (*id.* at 314). Although a panel of the Sixth Circuit in *Owen* v. *Commissioner*, 652 F.2d 1271, 1276 n.10, expressed apparent agreement with the Tax Court's conclusion as to the vitality of *Turner*, that panel decision was vacated by the court of appeals on September 11, 1981. Thus, the matter has hardly "been laid to rest," as petitioners claim (Br. 23). At all events, we submit that in determining the income tax consequences of net gifts, no distinction can be made between transfers to individuals and transfers in trust.

recognized that there was "much force" to the government's "more 'realistic' approach to the problem," it concluded that "in the absence of any clear-cut overruling of prior law by a Court of Appeals" that "[t]hings have gone too far by now to wipe the slate clean and start all over again" (*id.* at 315). In so holding, however, Judge Raum offered the following analysis that could be the basis of a decision upon such a clean slate (*ibid.*):

> The gift tax itself is imposed only upon the "net gift," *i.e.*, upon the gross amount of the property transferred minus the gift tax paid by the donee. In substance, a portion of the transferred property equal in value to the amount of the gift tax is not treated as having been part of the gift. But surely that portion did not vanish into thin air, and a strong argument can be advanced for the conclusion that it was exchanged for the donee's payment of the gift tax on the "net gift," a transaction that may result in the realization of gain or loss depending upon the donor's basis in the property. If the donor had sold that portion to an outsider immediately prior to the gift of the remainder, and then used the proceeds of the sale to pay the gift tax, the practical consequences to the donor would have been the same as in *Turner*, except that the donor would have been taxable on any gain realized on the sale.

In an en banc decision, the court of appeals affirmed. 572 F.2d 427 (4th Cir. 1978). Focusing on the taxpayer's alleged intent not to "sell" anything, the court held, in conformity with *Turner*, that the taxpayer had not realized taxable gain on the net gift transaction. The court noted that the taxpayer owed nothing prior to her decision to make the net gift and therefore concluded that "there was no economic gain of any kind accruing to her" and that she "received nothing" as a result of the transaction. *Id.* at 430-431. In the court's view

(*id.* at 431): "She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off."

Like the *Turner* decision which it follows, *Hirst* erroneously relies upon the donor's intent to make a gift, rather than a sale. But contrary to the court's conclusion, the taxpayer in *Hirst* was unquestionably "better off" as a result of the transaction. In parting with property with a low basis, she was relieved of her liability for payment of gift taxes in an amount substantially in excess of her basis. As the congressional reports pertaining to lifetime transfers state, the gift tax is "in reality * * * another 'cost' incurred in transferring the property from the donor to the donee, * * * which must be paid in order to make this transfer" (S. Rep. No. 1983, 85th Cong., 2d Sess. 70 (1958)). Since the donees in *Hirst* paid this "cost" on the taxpayer's behalf, the benefit to her was "as real and substantial" as if the donees had paid the applicable amount directly to the taxpayer. *Old Colony Trust Co.* v. *Commissioner, supra,* 279 U.S. at 729; *Crane* v. *Commissioner, supra,* 331 U.S. at 13.[24] An increase in net worth

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[24] *Crane* effectively refutes the amicus Owen's claim (Br. 19-21) that taxing the donor of a net gift exceeds the constitutional definition of income. The Court there explicitly held there is no constitutional prohibition against taxing the economic gain realized by the transferor of property upon the discharge of his indebtedness. As the Court stated (331 U.S. at 15; footnote omitted):

> Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit. If it is because the entire transaction is thought to have been "by all dictates of common sense * * * a ruinous disaster," as it was termed in her brief, we disagree with her premise.

See *James* v. *United States,* 366 U.S. 213, 218-220 (1961); *Commissioner* v. *Glenshaw Glass Co.,* 348 U.S. 426, 431 (1955); *Mer-*

is not a *sine qua non* of taxable income. Rather, taxable income can arise as well when appreciated property is used to satisfy an obligation.[25]

Nor can the gift transfer be equated to a father's payment of an obligation of his son, as *Hirst* suggested (572 F.2d at 431). In such a case, the father made a gift to the son. But as we have pointed out (*supra*, page 17), there can be no suggestion under the facts of these cases that the donees of the property in question were making gifts to the donors in paying the latters' gift taxes. Cf. *Commissioner* v. *Duberstein*, *supra*. As the dissent in *Hirst* properly observed: "Taxpayer's

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*chants' Loan & Trust Co.* v. *Smietanka*, 255 U.S. 509, 519 (1921). Here, as in *Crane*, petitioners (Br. 4) have characterized their net gift transfers as resulting in an economic loss. But, as we have pointed out (*supra*, pp. 12-13, 19-24), the donees' satisfaction of petitioners' gift tax liability benefitted petitioners in exactly the same manner as if the donees had paid petitioners an equivalent amount in cash.

[25] See Note, *Federal Income Tax—Net Gift Doctrine—No Taxable Income Results from Gift Given Subject to Condition that Donee Pay Gift Tax (Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (en banc))*, 63 Cornell L. Rev. 1074, 1082 (1978).

Other legal commentaries have similarly criticized the majority opinions in *Hirst*. *E.g.*, Note, *Taxation—Conditional Net Gift Transfers: No Income Tax Consequences to Donor—Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978)*, 52 Temple L.Q. 139 (1979); Comment, *Federal Income Tax—Income Taxation of Net Gifts After Hirst v. Commissioner*, 32 Rutgers L. Rev. 389 (1979); Note, *Taxation—Net Gift Transfer of Appreciated Real Property Held Not to Give Rise to Taxable Gain for the Donor*, 57 N.C. L. Rev. 476 (1979); Note, *Income Taxation of Net Gifts—Hirst v. Commissioner*, 38 Md. L. Rev. 110 (1978); Note, *The Donor of a Gift Made Subject to the Condition that the Donee Pay State and Federal Gift Taxes on the Transfer Does Not Realize Taxable Income Even Though Gift Taxes Paid Exceed the Property's Adjusted Basis—Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (en banc)*, 47 U. Cinn. L. Rev. 341 (1978).

argument that the payment of the taxes was a gift back to her is not supported by the facts stipulated by the parties and testified to by the son" (572 F.2d at 439 n.6).[26]

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[26] Petitioners and the amici further argue that the enactment in 1976 of Section 644 of the Code evidences Congress' implicit approval of the result reached in *Turner* and *Hirst*. Section 644 provides that if property transferred to a trust at less than its fair market value is sold by the trust less than two years later, the tax imposed on the sale is computed as though the transferor had made the sale. Section 644 thus erects a temporary barrier against a taxpayer's use of a trust to realize capital gains at a lower progressive rate structure.

But, contrary to petitioners' (Br. 34) and the amici's claims (Owen Br. 14-16; Cleaver Br. 23, 32-37), Section 644 has nothing to do with net gifts. Nowhere in the legislative history accompanying the passage of that provision is there any reference to the net gift cases such as *Turner* or *Johnson*. On the contrary, in enacting Section 644, Congress was not seeking either to codify or overrule the result reached in *Turner*. Rather, it was merely attempting to curb the "possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure." H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 186 (1976). The tax imposed under Section 644 applies whether or not gift taxes are imposed on the transfer, and if they are, who pays them; the statute also applies without regard to whether the transferor's basis in the property was greater or less than the gift taxes imposed on the transfer. In short, Section 644 is irrelevant to the determination whether a net gift transfer can result in taxable gain to the donor.

Finally, the amicus Owen argues (Br. 9, 15) that Section 644's temporary limitation of the bracket advantage for transfers in trust provides a remedy comparable to that sought by the government in the instant cases. This is incorrect. Imposing an income tax upon the donor of net gifts of highly appreciated property involves much more than the temporary elimination of the bracket advantage for transfers in trust. Rather, it determines the identity of the taxpayer who recognizes gain and it involves a significant timing aspect as well. If appreciated property is used to satisfy

**D. A decision in favor of the Commissioner's position should be fully applicable to petitioners in these cases**

Finally, petitioners (Br. 27-34) and the amici (Owen Br. 21-25; Cleaver Br. 37-43) claim that any decision by this Court in favor of the Commissioner should be prospective only, on grounds of *stare decisis* and their purported reliance on the Sixth Circuit's decision in *Turner*. As the court of appeals below correctly noted (Pet. App. A11), however, a taxpayer residing in one circuit may not avoid a tax otherwise due by claiming reliance upon a decision of another court of appeals. *Gulf Inland Corp* v. *United States*, 570 F.2d 1277, 1278 (5th Cir. 1978). Indeed, even reliance upon a decision of the court of appeals in the taxpayer's home circuit will not relieve him from taxation if the rule announced there is ultimately rejected by this Court. See *C. Blake McDowell, Inc.* v. *Commissioner*, 652 F.2d 606 (6th Cir. 1980), where the court of appeals held that a decision of this Court overruling existing case law in that circuit would be applied in all pending cases. Thus, in *United States* v. *Estate of Donnelly*, 397 U.S. 286 (1970), this Court's decision upholding the validity of a federal tax lien was applied even though the prevailing interpretation of the tax lien statute at issue in the taxpayer's home circuit would have invalidated the lien. Accord, *Hartman Tobacco Co.* v. *United States*, 471 F.2d 1327

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an obligation, there is a taxable event, and there is no reason to postpone the tax until a later date. Indeed, the property transferred may never be sold, thus postponing the tax indefinitely. Moreover, the tax abuse associated with net gift transfers and exemplified by the instant cases applies to outright transfers as well as to those in trust. As noted above, however, Section 644 has no application to outright transfers. Thus, it is altogether unreasonable to conclude that Congress, in enacting Section 644, intended to preclude income taxation of the gain the donor realizes in making net gift transfers.

(2d Cir. 1973); *Of Course, Inc.* v. *Commissioner*, 499 F.2d 754 (4th Cir. 1974); *Benedict Oil Co.* v. *United States*, 582 F.2d 544 (10th Cir. 1978).[27] See also *United States* v. *Darusmont*, 449 U.S. 292 (1981).

Thus, petitioners cannot escape taxation on the gain they realized from their net gift transfers by claiming that they relied on certain decisions holding that there was no taxable gain in those circumstances. This is especially true where, as here, the Commissioner has consistently taken the position that such transfers can result in taxable gain.[28] As this Court observed in *Estate of Donnelly*, *supra*, 397 U.S. at 294-295:

> Acts of Congress are generally to be applied uniformly throughout the country from the date of their

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[27] In *Benedict Oil Co.*, 582 F.2d at 549, the court quoted with approval the following language from one of its earlier opinions (*Sunray Oil Co.* v. *Commissioner*, 147 F.2d 962, 963-964 (10th Cir.), cert. denied, 325 U.S. 861 (1945) (footnotes omitted)):

> There is no vested right in the decisions of a court and a change of decision does not deprive one of equal protection of the laws or property without due process of law. It is a general rule that the decision of the highest appellate court of a jurisdiction overruling a former decision is retrospective in its operation. In effect, it declares that the former decision never was law.

[28] See, *e.g.*, Treasury Regulations § 1.1001-1(e), *supra* (originally promulgated as T.D. 6265, 1957-2 Cum. Bull. 463, 468, 22 Fed. Reg. 8935 (1957)); Rev. Rul. 70-626, 1970-2 Cum. Bull. 158; Rev. Rul. 71-232, 1971-1 Cum. Bull. 275, superseded by Rev. Rul. 75-72, 1975-1 Cum. Bull. 310. As the court noted in *Owen* v. *Commissioner*, *supra*, 652 F.2d at 1274: "[T]he Commissioner [has] never accepted the notion that a net gift results in no taxable income to the donor for income tax purposes."

Since the Commissioner's position regarding net gift transfers has been made clear in the pertinent Treasury Regulations for almost 25 years, a taxpayer cannot avoid the income tax consequences of his actions by looking for guidance only to the Regulations pertaining to the gift tax, as the amicus Cleaver argues (Br. 38-39).

> effectiveness onward. Generally the United States, like other parties, is entitled to adhere to what it believes to be the correct interpretation of a statute, and to reap the benefits of that adherence if it proves to be correct, except where bound to the contrary by a final judgment in a particular case. Deviant rulings by circuit courts of appeals, particularly in apparent dictum, cannot generally provide the "justified reliance" necessary to warrant withholding retroactive application of a decision construing a statute as Congress intended it.

In short, "Congress has indicated that, in federal tax law, claims of reliance are to be given little weight." *Gulf Inland Corp.* v. *United States*, *supra*, 570 F.2d at 1279. In making the net gift transfers at issue, petitioners simply ran the risk that the rule of law announced in *Turner* would not ultimately survive. *C. Blake McDowell, Inc.* v. *Commissioner*, *supra*, 652 F.2d at 607. See *United States* v. *Darusmont*, *supra* (upholding Congress' "retroactive" application of the 1976 amendments to the minimum tax). As this Court held in *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971), judicial decisions should be applied to all pending cases unless a "new principle of law" is established that would be aided by prospective application only, and nonretroactive treatment would avoid substantial inequitable results. Accord, *Wilson* v. *United States*, 588 F.2d 1168 (6th Cir. 1978). Taxing petitioners on the gain they realized upon their transfers of appreciated property does not produce "substantial inequitable results."

## CONCLUSION

The judgment of the court of appeals should be affirmed.[29]

Respectfully submitted.

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DECEMBER 1981

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[29] In both of these cases, the Commissioner took the position that the gain was taxable in the year the gift taxes were paid, rather than in the year the net gift transfer was made. In *Old Colony Trust Co., supra*, payment by a third party of a taxpayer's income tax liability was held to be the equivalent of the receipt of income by the person taxed, and thus constituted taxable income to the taxpayer in the year the tax was paid, despite the fact that the third party's agreement to pay the taxes was executed in a preceding year. 279 U.S. at 729. See *Hirst* v. *Commissioner*, *supra*, 572 F.2d at 439 (separate opinion of Judge Thomsen). As the court below noted (Pet. App. A2, n.2), petitioners have agreed that if taxable gain is realized as a result of their net gift transfers, the gain is properly taxable in the year the gift taxes were paid. There are, however, several net gift cases pending in the courts of appeals that present this timing question, arising from the fact that the gift taxes were paid in taxable years subsequent to the year of the gift. See, *e.g.*, *Davis* v. *Commissioner*, 74 T.C. 881 (1980), appeal pending, No. 81-1187 (6th Cir.); *Bradford* v. *Commissioner*, 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.); *Estate of Currey* v. *Commissioner*, 41 T.C.M. (CCH) 800 (1981), appeal pending, No. 81-1423 (6th Cir.); *Estate of Weeden* v. *Commissioner*, 39 T.C.M. (CCH) 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *Benson* v. *Commissioner*, 37 T.C.M. (CCH) 989 (1978), appeal pending, No. 79-1032 (6th Cir.). If, as we urge, the Court affirms the judgment below, it may wish to clarify the timing question in order to obviate the need for further litigation on this collateral issue.

## APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)*):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property.

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) *Cross References*—For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

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* Section 644 and Section 1015(d)(6) are codified in 26 U.S.C. (1976 ed. & Supp. III).

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

SEC. 644 [as added by Section 701(e)(1), Pub. L. 94-455, 90 Stat. 1578, and amended by Section 701(p)(1-2), 92 Stat. 2908). SPECIAL RULE FOR GAIN ON PROPERTY TRANSFERRED TO TRUST AT LESS THAN FAIR MARKET VALUE.

(a) *Imposition of Tax.*—

(1) *In general.*—If—

(A) a trust (or another trust to which the property is distributed) sells or exchanges property at a gain not more than 2 years after the date of the initial transfer of the property in trust by the transferor, and

(B) the fair market value of such property at the time of the initial transfer in trust by the transferor exceeds the adjusted basis of such property immediately after such transfer,

there is hereby imposed a tax determined in accordance with paragraph (2) on the includible gain recognized on such sale or exchange.

(2) *Amount of tax.*—The amount of the tax imposed by paragraph (1) on any includible gain recognized on the sale or exchange of any property shall be equal to the sum of—

(A) the excess of—

(i) the tax which would have been imposed under this chapter for the tax-

able year of the transferor in which the sale or exchange of such property occurs had the amount of the includible gain recognized on such sale or exchange, reduced by any deductions properly allocable to such gain, been included in the gross income of the transferor for such taxable year, over

(ii) the tax actually imposed under this chapter for such taxable year on the transferor, plus

(B) if such sale or exchange occurs in a taxable year of the transferor which begins after the beginning of the taxable year of the trust in which such sale or exchange occurs, an amount equal to the amount determined under subparagraph (A) multiplied by the annual rate established under section 6621.

The determination of tax under clause (i) of subparagraph (A) shall be made by not taking into account any carryback, and by not taking into account any loss or deduction to the extent that such loss or deduction may be carried by the transferor to any other taxable year.

(3) *Taxable year for which tax imposed.*—The tax imposed by paragraph (1) shall be imposed for the taxable year of the trust which begins with or within the taxable year of the transferor in which the sale or exchange occurs.

(4) *Tax to be in addition to other taxes.*—The tax imposed by this subsection for any taxable year of trust shall be in addition to any other tax imposed by this chapter for such taxable year.

(b) *Definition of Includible Gain.*—For purposes of this section, the term "includible gain" means the lessor of—

(1) the gain recognized by the trust on the sale or exchange of any property, or

(2) the excess of the fair market value of such property at the time of the initial transfer in trust by the transferor over the adjusted basis of such property immediately after such transfer.

(c) *Character of Includible Gain.*—For purposes of subsection (a)—

(1) the character of the includible gain shall be determined as if the property had actually been sold or exchanged by the transferor, and any activities of the trust with respect to the sale or exchange of the property shall be deemed to be activities of the transferor, and

(2) the portion of the includible gain subject to the provisions of section 1245 and section 1250 shall be determined in accordance with regulations prescribed by the Secretary.

* * * * *

SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable in-

come and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * * * *

SEC. 1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

(a) *Gifts After December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary or his delegate shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obtain, such property was acquired by such donor or last preceding owner.

* * * * *

(d) [as added by Section 43(a), Pub. L. 85-866, 72 Stat. 1640] *Increased Basis for Gift Tax Paid.*—

(1) *In general.*—If—

(A) the property is acquired by gift on or after the date of the enactment of the Technical Amendments Act of 1958, the basis shall be the basis determined under subsection (a), increased (but not above the

fair market value of the property at the time of the gift) by the amount of gift tax paid with respect to such gift, or

(B) the property was acquired by gift before the date of the enactment of the Technical Amendments Act of 1958 and has not been sold, exchanged, or otherwise disposed of before such date, the basis of the property shall be increased on such date by the amount of gift tax paid with respect to such gift, but such increase shall not exceed an amount equal to the amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of the donor at the time of the gift.

* * * * *

(6) [as added by Section 2005(c), Pub. L. 94-455, 90 Stat. 1877] *Special rule for gifts made after December 31, 1976.*—

(A) *In general.*—In the case of any gift made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as—

(i) the net appreciation in value of the gift, bears to

(ii) the amount of the gift.

(B) *Net appreciation.*—For purposes of paragraph (1), the net appreciation in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift.

* * * * *

§ 2501 [as amended by Section 109(a), Pub. L. 89-809, 80 Stat. 1574, and Section 102(a)(1), Pub. L. 91-614, 84 Stat. 1838]. Imposition of tax.

(a) *Taxable transfers.*

(1) *General rule.*

For the first calendar quarter of calendar year 1971 and each calendar quarter thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar quarter by any individual resident or nonresident.

* * * * *

§ 2502. Rate of tax.

(a) [as amended by Section 102(a)(2), Pub. L. 61-614, 84 Stat. 1839] *Computation of tax.*

The tax imposed by section 2501 for each calendar quarter shall be an amount equal to the excess of—

(1) a tax, computed in accordance with the rate schedule set forth in this subsection, on the aggregate sum of the taxable gifts for such calendar quarter and for each of the preceding calendar years and calendar quarters, over

(2) a tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable gifts for each of the preceding calendar years and calendar quarters.

* * * * *

(d) *Tax to Be Paid by Donor.*—The tax imposed by section 2501 shall be paid by the donor.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.1001-1(e)

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in

part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2.

* * * * *

§ 1015-4. *Transfers in part a gift and in part a sale.*

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of—

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) These amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see § 1.1001-1(e) and § 1.1011-2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and § 1.170A-4(c).

* * * * *

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UNITED STATES SUPREME COURT

OCTOBER TERM 1981

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V.P. DIEDRICH and
FRANCES T. DIEDRICH, and

UNITED MISSOURI BANK OF KANSAS CITY,
N.A., EXECUTOR OF THE ESTATE OF
FRANCES D. GRANT,

Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

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On Writ of Certiorari From
The United States Court of Appeals
For The Eighth Circuit

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# BRIEF FOR LAIRD C. CLEAVER AND KAREN K. CLEAVER AS AMICUS CURIAE

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## SUMMARY OF ARGUMENT

The first argument presented by amicus curiae is based on the framework of the Internal Revenue Code (IRC). Congress structured the IRC to provide separate taxes for separate transactions, the income tax, the gift tax and the estate tax. An example of this Congressional intent can be found in sec. 1015 and sec. 2501 of the IRC and the treasury regulations thereunder. The gift tax consequences occur at the time of transfer when the gift tax is levied. The income tax consequences occur at the time the donee disposes of the property using the basis determined under sec. 1015 IRC to compute the taxable gain to the donee. The transfer before this Court is a gift transfer and the only applicable IRC sections are sec. 2001 and sec. 2501.

In Part C of the Argument, amicus curiae contends that while the donor is liable for the gift tax under sec. 2502(d) IRC, the IRC also provides that if the gift tax is not paid when due the donee becomes personally

liable for the gift tax to the extent of the value of the gift under sec. 6324(b) IRC. Thus, payment of the gift tax also has an economic benefit to the donee who upon payment of the tax is assured that the lien imposed by sec. 6324(b) IRC is extinguished. This payment of the gift tax liability, imposed by operation of law, is thus not the release of liability taxable under the Crane doctrine.

The third argument of the amicus curiae is based on Congressional inaction regarding the net gift income tax issue. For eight years prior to the enactment of the Tax Reform Act of 1976, Congress was aware of the part gift, part sale theory promulgated by the Commissioner of Internal Revenue (Commisioner) and of the rejection of such theory by the Tax Court, and the Fourth, Fifth and Sixth Circuit. Congress however did not legislate a result contrary to the impressive precedent. Legislation is to be construed in terms of judicial precedent in existence at the time of the enactment and when such precedent is not corrected, approval of it

must be assumed.

The final argument presented involves the reliance by taxpayers on legal precedent. In order to promote intelligent tax planning, taxpayers must be able to rely on the legal precedents existing at the time they are making a decision. In this case legal precedent existing at the time the gifts were made included IRC provisions and treasury regulations which provided separate taxes for disposition of property by gift and by sale. Revenue Rulings regarding net gifts failed to state the Commissioner's position regarding income tax consequences of a part gift, part sale. In addition over eight years of case law rejected the Commissioner's position. After all these years of legal precedent, it is too late to change the law for taxpayers who relied on years of legal precedent for guidance in their tax planning.

## I. INTEREST OF AMICUS CURIAE

The amicus curiae, Laird C. Cleaver and Karen K. Cleaver, his wife (herein "Cleavers"), pursuant to the spousal gift splitting provisions set forth at sec. 2513 IRS, on December 17, 1976, gifted $1,895,312.50 worth of highly appreciated stock, to an irrevocable trust established for the benefit of Mr. Cleaver's issue on the express condition that the trustees pay any gift taxes imposed on the transfer. In 1977, the trustees paid federal gift taxes of $357,563.75 and state gift taxes of $158,218.60, for a total of $515,782.25. The trustees raised the dollars to pay the tax by borrowing from a third party.

The Internal Revenue Service (IRS) issued its notice of deficiency to the Cleavers on May 13, 1981, for income tax deficiencies for calendar year 1976 claiming additional income taxes due of $178,866.00 relating to the gift; the IRS claims the income tax on the basis that the gift was a part sale and the Cleavers recognized taxable gain equal to the

difference between the basis in the property transferred and the gift taxes paid. The issue is presently pending in the United States Tax Court, Docket No. 10959-81. The IRS issued an additional deficiency notice for the same event for calendar year 1977, and the Cleavers will shortly file their petition in the Tax Court for that year.

The issues presented in the subject case are identical to those faced by the Cleavers, and the Cleavers desire to advise the Court of their interest and position.

## II. ARGUMENT

### A. INTRODUCTION AND CASE LAW HISTORY

In the case at bar, the IRS seeks to impose an income tax consequence on a gift transaction. The IRS argues that since the gift was conditioned upon the donee paying the gift tax, it is in reality a part sale. The IRS contends that because sec. 2502(d) IRC places the liability to pay the gift tax upon the donor, and the donor is relieved of that liability by the donee's agreement to pay the

gift tax, the donor has been relieved of a liability, and accordingly the donor realizes gain to the extent that the value of the release of that liability exceeds his basis under the principles of Crane v. Commissioner, 331 U.S. 1 (1947) and Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

The amicus curiae submits the IRS is incorrect in its position for several reasons. Firstly, Congress has explicitly stated the income tax consequences for gift transactions and established two separate coordinated taxes depending upon the nature of the transfer of property, thereby precluding the IRS from creating fictions to impose dual taxes upon the same event of transfer.

Secondly, the release of liability of the donor imposed by sec. 2502(d) IRC, relied upon so heavily by the IRS to trigger the gain, is not solely the liability of the donor. Under sec. 6324(b) IRC, a lien exists against the property gifted until the gift tax is paid, and the donee is personally liable to the extent of the value of the property gifted if

the tax is not paid when due.

Thirdly, in passing the Tax Reform Act of 1976, Congress specifically addressed the income tax consequences for gifting highly appreciated property to irrevocable trusts without overruling the longstanding case law precedent rejecting the IRS's part gift, part sale argument, thereby adopting the same.

Fourthly, longstanding precedent existed in the Fourth, Fifth and Sixth Circuit Courts of Appeal as well as the Tax Court protecting the taxpayers involved in the case at bar from the income tax consequences sought to be imposed by the IRS, and any change in those tax consequences should be applied prospectively only.

Each of these arguments will be developed seriatim below. However, since the case law history of the IRS's attempts to impose income tax consequences on gift transactions is relevant to all of these arguments, it is set forth at this point in the brief.

The Service first attempted to impose an income tax consequence to a gift to a trust

based on the argument the donor-grantor reserved a portion of the trust income for the purposes of paying the gift tax liability. One of the first cases to address this issue was Estate of A. E. Staley, Sr. 47 B.T.A. 260 (1942) aff'd 136 F.2d 368 (5th Cir. 1943). cert. den. 320 U.S. 786 (1943). In Staley the taxpayer-donor gave $2,000,000 worth of stock to a trust in return for the trustee's promise to pay the first $150,000 of trust income to the donor. The Board of Tax Appeals held and the Fifth Circuit affirmed that the $150,000 was taxable income to the donor based on the reasoning that the donor's intent was a gift of the entire $2,000,000 with a reserved interest in the first $150,000 of income to help pay the gift tax liability.

The next significant decision in this area was Estate of Craig R. Sheaffer, 37 T.C. 99, aff'd 313 F.2d 738 (8th Cir. 1963) cert. den. 375 U.S. 818 (1953) in which the taxpayer-donor created four separate trusts by transferring 70,000 shares of stock. The trustee of the trusts agreed to assume and pay

all gift taxes relating to the transfer. The trustee paid the tax liability using dividend income from the transferred stock and borrowed funds. The Tax Court found and the Eighth Circuit affirmed that sec. 667 IRC applied. Under sec. 667 IRC, supra, the grantor is treated as the owner of a portion of a trust whose income may be distributed to the grantor. The Courts found that the trust's dividend income was used to pay the gift tax liability and thus, it was taxable income to the donor on the basis that the donor reserved part of her gift to the trust for her own benefit.

The next case to deal with this issue was Estate of Annette S. Morgan, 37 T.C. 981 (1962) aff'd 316 F.2d 238 (6th Cir. 1963) cert. den. 375 U.S. 825 (1963) which involved such factual differences from Staley, supra, and Sheaffer, supra, that the Tax Court and the Sixth Circuit reached an opposite conclusion. In Morgan, supra, a decedent established certain trusts by the transfer of stock. The trust agreement stated that the trustees should

pay the donor's gift tax liability, with the trustees having the discretion to pay such liability by either selling the corpus or borrowing. The trustees borrowed the money needed for the gift tax liability and repaid the loan from income earned by the trust in the years following. The Tax Court concluded that the decedent received no benefit from the fact that the trustees borrowed money to discharge her obligation because she did not retain an interest in the trust and could not recover the trust corpus.

With the Morgan, supra decision came a new sublety in this area in that the repayment by a trust of a loan, (the proceeds of which were used to pay the gift tax liability) out of trust income of a later year does not give rise to taxable income to the donor under sec. 667 IRC, but use by a trust of current income to pay the gift tax liability is taxable income to the donor under sec. 667 IRC.

Because gifts to trusts could now be structured to avoid the income tax consequences of sec. 667, the Commissioner developed a new

theory for the imposition of income tax to a gift situation based on sec. 61 and sec. 1001 IRC, referred to as the part gift, part sale. The Commissioner's first opportunity to present this theory in this context was in Turner v. Commissioner, 49 T.C. 356 (1968) aff'd per curiam 410 F.2d 752 (6th Cir. 1969). Factually, Turner, supra involved a transfer of low basis highly appreciated stock to three individuals and six trusts. Each donee signed a letter agreeing to pay their share of the gift tax. The donees subsequently gave the donor a check for their share of the gift tax liability. The Commissioner argued that the donor's gift of stock to each individual was a part sale, part gift and resulted in taxable capital gain income to the donor equal to the excess of the gift tax paid by the donee over the basis of the stock gifted. The Tax Court rejected the Commissioner's argument and concluded that each transaction was more appropriately characterized as a net gift; a gift of the property less the amount of gift tax due on the transfer. In resolving this issue the Tax Court

reviewed the above cited cases dealing with the income tax consequences of a transfer to a trust subject to an agreement by the transferee to pay the donor's gift tax. The Tax Court then rejected the Commissioner's position that the transaction was part sale, part gift which would result in taxable income to the donor; rather the Tax Court concluded that the transaction should more appropriately be characterized as a net gift; that is, a gift of the property less the amount of gift tax due on the transfer.

The Tax Court in Turner, supra indicated that the critical factor in this type of situation is the substance of the transaction rather than the form. When a donor attaches a condition to a gift transfer, such as the donee paying the gift tax, what the donor intended was a net gift, not a sale. The Tax Court's decision in Turner, supra, was appealed to the Sixth Circuit which affirmed the decision.

Since Turner, supra was decided in 1968, the Tax Court has had ample opportunities to

reverse itself and adopt the Commissioner's position of a part sale, part gift. One such opportunity came in Victor W. Krause, 56 T.C. 1242 (1971) (6th Cir. dismissed appeal 6-27-72) where Mr. Krause donated stock to three trusts and the trustees agreed to pay the gift tax liability. The trustees had the discretion to pay the gift tax liability out of the trust income, sale proceeds of the corpus or borrowed funds. The gift tax was paid with borrowed funds, but after the trust had earned some income. The Tax Court held under sec. 667 IRC the donor was taxable on the trust income . which was avilable to discharge his legal obligation to pay the gift tax; however, he was not taxable on the amount of borrowed funds used to pay the gift tax liability nor the trust income earned after the gift tax liability was paid. The Commissioner's argument that the transaction was a part sale, part gift was again rejected.

The Tax Court again had an opportunity to adopt the Commissioner's part sale, part gift argument in Estate of Kenneth W. Davis,

30 T.C. M. 136 aff'd per curiam 469 F.2d 694 (5th Cir. 1972). Factually, Davis, supra involved a gift of stock to one individual and two trusts with the condition that the donees pay the gift tax liability. At the time of the gift the trusts had sufficient assets to pay the gift tax without receiving dividends on the gifted stock. The Commissioner argued that the donor received taxable income on the three transfers based on the reason that the gift to the individual donee was a part sale, part gift and that the gift to the trusts was a retention of an income interest in the trust in an amount equal to the tax paid. Adhering to the precedent established in Turner, supra, and Krause, supra, the Tax Court concluded that no income was taxable to the donor.

After these failures, the Commissioner finally found a factual situation which lent itself to the part gift, part sale theory. The case was J. W. Johnson v. Commissioner, 59 T.C. 791, aff'd, 495 F.2d 1072 (6th Cir. 1974). Factually, in Johnson, supra, the do-

nor borrowed $200,000 on a non-recourse note, using 50,000 shares of appreciated stock as security. The donor then established an irrevocable trust and transferred the 50,000 shares of stock to the trust which assumed the liability for repayment of the note. The donor subsequently paid the gift tax liability of $150,000 out of loan proceeds and kept the remaining $50,000. The Sixth Circuit found that the donor had realized something of value as a result of this gift, that is, he was relieved of the note which encumbered the stock, and therefore had received a taxable gain.

The acceptance of the Commissioner's position in Johnson, supra, did not lead to the acceptance of the part gift, part sale theory in all situations. This can be illustrated by the Fourth Circuit's opinion in Hirst v. Commissioner, 63 T.C. 307 (1974) aff'd 572 F.2d 427 (4th Cir. 1978) (en banc). Factually, in Hirst, supra, the donor Mrs. Hirst, gifted her interest in three pieces of real estate. The donee agreed to assume the

gift tax liability. The worth of the gifts was determined by reducing the value of the transferred real estate by the amount of the gift tax liability. The Tax Court, following the precedent established by Turner, supra, held that Mrs. Hirst was not liable for income taxes on the transaction. On appeal, the Fourth Circuit affirmed the Tax Court's decision relying heavily on Turner, supra, because of the identical fact situation. The Fourth Circuit further justified its decision in Hirst, supra, by stressing that the transaction was not intended by the parties as a sale; but was intended as an intra familial gift; and further Mrs. Hirst, as the donor, received nothing of value as a result of the transaction.

Since 1976 there have been three reported cases, including the one before the Court, dealing with the income tax consequences of a net gift and all of them except Diedrich, supra have held that the donor shall have no income tax consequences as a result of his gift. Estate of Henry, 69 T.C. 665 (1978) involved a gift of stock to a trust on the

condition the trust pay the gift tax. The Tax Court applied the Turner, supra, line of cases and held the donor did not realize taxable income as a result of the net gift transfer. The second case was John T. Benson v. Commissioner, 37 T.C.M. 1978-231 (1978) in which parents transferred stock to their sons conditioned upon sons' payment of the gift tax. Finding the facts presented to be identical to those presented in Turner, supra, the Tax Court held the donors did not realize taxable gain on the gift transfer.

B. WITH RESPECT TO TRANSFERS OF PROPERTY CONGRESS HAS ENACTED SEPARATE TAXES DEPENDING UPON THE NATURE OF THE TRANSFER AND HAS SPECIFICALLY PRESCRIBED THE RULES FOR INTERACTION OF SUCH TAXES TO AVOID THE IMPOSITION OF BOTH TAXES UPON A SINGLE TRANSFER.

Congress has recognized that property can be transferred by sale or exchange, gift, or death, and has imposed a separate tax upon the transfer depending upon the type of transfer. A sale or exchange of property is taxable as income under secs. 61, 1001, and 1002 IRC. Property transferred by gift or inheritance is

excluded from income tax under sec. 102 IRC, but is taxed respectively under sec. 2501 IRC and sec. 2001 IRC.

With respect to gifts, Congress has specifically mandated how the basis of such property in the hands of the donee is to be calculated for subsequent sales or exchanges subject to income tax. Sec. 1015 IRC specifically provides that for gifts made after Septemter 2, 1958, and on or before December 31, 1976, the basis of property transferred by gift in the hands of the donee is the basis the donor had in the property increased by the gift tax paid. Sec. 1015 does not say increased by the "gift tax paid by the donor", but rather says increased by the "gift tax paid", regardless of who pays it. In short, Congress did not care who paid the gift tax. Indeed, the donee may well be liable for the payment of the gift tax under sec. 6324(b) IRC.

The addition to the donee's basis for the amount of the gift tax paid was added by Congress in 1958. At that time Congress specifically addressed what income tax consequence

the payment of the gift tax had. Instead of saying that there may be an income tax imposed depending upon who pays the tax, Congress said the amount of the gift tax - regardless by whom paid - should have the following income tax consequence: add it to the donee's basis because it is a "cost" for the gift transfer which should be recognized as such upon any subsequent taxable sale or exchange of the property:

> Under present law where property is acquired by gift it is generally considered to have the same basis in the hands of the donee for purposes of computing gain, loss, depreciation, or amortization as it had in the hands of the person who made the gift. Where donated property is subsequently sold at a loss, however, the recognized loss is limited to the excess of the fair market value of the property at the time (when this value is below the basis at that time) it was given to the donee over the amount received.
>
> In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its "cost". In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in trans-

> ferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total "costs" incurred with respect to donated property it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.
>
> As a result, your committee has added a new subsection to the section of present law (sec. 1015) specifying the basis for property acquired by gift. In this new subsection it is provided that the basis of property acquired by gift, after the date of enactment of this bill, is to be increased by the amount of any gift tax paid with respect to the donated property. 1958 U.S. Code Congressional and Administration News, Senate Report, Vol. 3, pg. 4859.

Surely, had Congress viewed the payment of the gift tax as the type of liability, which, if discharged by the donee, would be taxable to the donor as income, it would not have enacted the 1958 amendment specifically telling taxpayers what to do with the gift tax for income tax purposes.

The basis of property acquired by gift is determined under sec. 1015(a) IRC and sec. 1.1015-1(a) Income Tax Reg provides in general that the donee's basis for the purpose of determining gain is the same as the donor's

basis at the time of the gift. Thus the appreciation of the gifted property is taxed upon the donee's disposition of the property. This has been the consistent policy of Congress in the IRC and adoption of the Commissioner's part gift, part sale theory would be in contravention to such intent.

A further indication that the intent of the IRC is not to imply income tax consequences to a gift transfer can be found in sec. 1.1015-4, Income Tax Regs. This section deals with the basis of property acquired in a part gift, part sale transfer, and provides as follows:

> (a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of
>
> (1) Whichever of the following is the greater:
> (i) The amount paid by the transferee for the property; or
> (ii) The transferor's adjusted basis for the property at the time of the transfer, and
>
> (2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see §1.1015-5).

If one were to apply the Commissioner's concept that the amount of the gift tax paid by the donee is the amount of consideration paid by the donee, the basis of the gifted property where the gift tax exceeded the donor's basis would be an amount equal to twice the gift tax paid, since under sec. 1.1015 Income Tax Regs the gift tax represents both the amount paid by the transferee and the amount of the gift tax paid. Adoption of the Commissioner's part gift, part sale theory thus allows the donee to be credited twice with the gift tax. The fact that this type of result can occur indicates once more that the part gift, part sale theory is contrary to the policy of the IRC. It should also be noted, that every example presented in sec. 1.1015-4 Income Tax Regs to illustrate a part gift, part sale involves a sale of property for less than its fair market value, another indication that a net gift was never intended to have the income tax consequences of a part sale, part gift.

It is a well established principle of

law that statutes must be interpreted to reflect the intent of those who drafted them. This principle applies equally to the IRC.

> It is a cardinal principle that in construing a statute the intention of the law-making body should prevail and, if a literal interpretation of a part of a statute operates unjustly or leads to absurd results, or is contrary to the evident meaning of the act taken as a whole, it should be rejected (... authorities cited).
>
> Taxation is a highly practical matter. The revenue act must be construed as a whole, and a sensible construction, one which will effectuate the legislative intention, should be given. The various sections of the act should be so construed that one section will explain and support and not defeat or destroy another section (authorities cited) Brons Hotels, Inc., 34 B.T.A. 376 (1936) at 38..

Further, as part of the Tax Reform Act of 1976, Congress enacted sec. 644 IRC, effective May 21, 1976, which again addressed the income tax consequences of a gift transfer. The impact of sec. 644 IRC is more fully developed at Part D of the Agreement, but once again demonstrates Congress' intent of a separate tax for a separate type of transfer.

The above analysis of the applicable Code provisions establishes that the Commissioner's position disregards the above quoted principle of statutory construction in that the entire structure of the IRC separates gift taxes from income taxes, and mandates that these are separate taxes imposed for separate types of transfers of property. The gift tax is imposed on the transfer of property, and is to be paid as a privilege of such transfer. It may be paid by the donor under sec. 2502(d) IRC or by the donee under sec. 6324(b) IRC, and once paid - regardless by whom - is to only have income tax consequences with respect to the computation of the donee's basis. Congress simply did not provide for it to have any other income tax consequences, just as there are no income tax consequences for the remainderman's interest in estate property to bear the burden of the estate tax for a specific bequest.

The foregoing analysis is the rationale behind the Tax Court's decision in Turner

supra. The Tax Court never got by the threshold question: Is the transfer of property a gift or is it a sale? Once determining that it was a gift transfer, it concluded the IRS's fiction of a part sale was inapposite:

> In all of the above cases, both in a gift tax and income tax context, the major premise of each decision is that a condition imposed by the transferor that the transferee will pay the gift tax resulting therefrom does not alter the result that the transfer constituted a gift. The rationales of the above cases are totally inconsistent with a finding that the transfer was a part sale, part gift. The respective courts in the above cases have, in our opinion, looked at the facts of each case, including the close family relationships involved, and have determined what was in fact intended by the parties. Turner v. Commissioner, supra, 49 T.C. at 362.

C. IN PAYING THE GIFT TAX THE DONEE IS DISCHARGING HIS OWN LIABILITY.

The major premise of the IRS's argument is that the agreement of the donee to pay the gift tax constitutes a shift of the donor's liability to pay the tax under sec. 2502(d) IRC to the donee, and therefore under the teachings of Crane, supra, and Old Colony Trust, supra is recognized as gain for income tax purposes. However, sec. 6324(b) IRC

provides in part:

> Except as otherwise provided in subsection (c), unless the gift tax imposed by chapter 12 is sooner paid in full or becomes unenforceable by reason of lapse of time, such tax shall be a lien upon all gifts made during the period for which the return was filed for 10 years from the date the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.

Clearly, whether the donee specifically agrees to pay the tax or not, he has a significant liability for the gift tax and interest in the tax being paid. The donee may well desire to pay the gift tax to assure himself the lien is extinguished and his personal liability is gone. Neither Diedrich which is before the Court, nor Johnson, supra, relied upon so heavily by the Eighth Circuit in deciding Diedrich, ever considered the donee's liability for the gift tax.

Congress chose to make the donee, as well as the donor, liable for the gift tax because it desired to have the tax imposed upon this type of transfer paid. If the donee pays

this tax liability imposed upon by him by law, it simply should not result in an additional and different taxable event to the donor.

Under sec. 2513 IRC, a spouse who has no interest in the property gifted may join in the gift to reduce the gift taxes payable by reason of the transfer by gift. However, under sec. 2513(d) IRC the spouse who so joins in the gift is jointly and severally liable for the gift tax. Was it Congress' intent to trap the donor into an income tax consequence by authorizing the donor's spouse to assume joint and several liability for the gift tax which would otherwise be the liability of the donor under sec. 2502(d) IRC? To be consistent under the IRS' theory in this case the answer would have to be yes. However, that is clearly not what Congress intended. It intended to permit the spouse to join in the gift so that married couples could reduce the gift taxes imposed by reason of transfer of their spearate property. Further, Congress mandated the tax consequences for the spouse doing so - joint and several liability for the gift tax.

Congress simply never intended any income tax consequences to anyone regardless of who paid the gift tax.

The taxable "release of liabilities" reached under Crane, supra, and Old Colony Trust, supra, have economic reality associated with them. For example, a taxpayer who borrows money by encumbering property in excess of his basis realizes gain in excess of his basis at the time of the borrowing; however the gain is not recognized because borrowing is not a sale or exchange. When the taxpayer transfers the property and is relieved of the encumbrance and liability, he has a permanent economic benefit. There is no obligation imposed by law upon the purchaser of such property that he assume such liability or take the property subject to such liability as a condition of the transfer.

Conversely, in the gift situation, the donee by virtue of sec. 6324(b) IRC, can only receive the transfer subject to the liability for the lien for gift taxes imposed upon such property, and subject to the personal liability for such gift tax to the extent of the

value of such property at the time of the gift. With respect to the gift transfer, the donor has realized zero less his tax basis in the property transferred. The loss of this tax basis to the donor is not recognized by the donor because the nature of the transaction is not a sale or exchange, but rather a gift, and under sec. 1015 IRC the donor's basis in the property is rolled over to the donee to be subsequently taken into account on a sale or exchange by the donee.

In effect, the IRS contends that the donor, who has already realized a non-recognizable loss for his gift transfer should be credited with his basis but saddled with the "release" of the gift tax liability as the amount realized, and that the gain should be recognized because the property is transferred. However, the "liability released" is also the donee's liability and the transfer itself is not a sale or exchange but a gift.

The IRS' argument compares apples to oranges. In effect, the IRS contends the donor cannot make a net gift and end up with

zero; his property is gone, his basis in the property is gone without realizing a loss under sec. 1001 IRC, and he has an income tax liability. This cannot be the result where Congress has said the donee can pay the gift tax.

D. BY NOT CHANGING THE RESULTS OF THE EXISTING CASE LAW WHEN IT ENACTED THE TAX REFORM ACT OF 1976, CONGRESS APPROVED SUCH CASE LAW.

With the passage of the Tax Reform Act of 1976, Congress drastically altered the federal gift and estate tax provisions. Generally, prior to December 31, 1976, there were separate graduated tax rate schedules for gifts and estates. By gifting property, and excepting gifts in contemplation of death, a taxpayer could permanently exclude the value of the gift from his estate. Thus, a taxpayer through a planned gift program could balance the taxes imposed by gift or at death at approximately equal tax rates under the respective graduated schedules. The tax benefit then would be realized at death when the

taxpayer's estate, reduced by the value of prior gifts, would be taxed at lesser rates than if the gifted property had been included in the estate.

Effective January 1, 1977, Congress abolished this system, and established a single tax rate schedule for gifts and estates and phased in the unified credit for both purposes. The effect of this change made it easier for taxpayers to make gifts without incurring an immediate gift tax because of the unified credit, but also made all taxable gifts after December 31, 1976, includible in the gross estate of the donor at the value of the property at the time of the gift; the estate tax is then calculated at the graduated rates including the gifted property, and the taxpayer receives a credit for any gift tax paid. In effect, after December 31, 1976, a taxpayer could only exclude the appreciation of the property after the gift from the estate tax.

In enacting this massive overhaul of the method used to tax gifts, Congress did not alter any of the income tax consequences to

the donee's basis, nor did it change in any way the philosophy of excluding gifts from income and the definition of gift transfer vis-a-vis sale or exchange transfers. It did, however, specifically address one concern it had for the transfer by gift of highly appreciated property to a trust in creating sec. 644 IRC, effective May 21, 1976.

Sec. 644 IRC, in effect, requires the income tax computation for the sale or exchange of property received by a trust, if disposed of within two years of its receipt, to be calculated using the donor's income tax bracket and not the trust's bracket. The abuse sought to be avoided by this section was the escape by the donor from paying income taxes at his rates by gifting property to a trust which would presumably have lower rates:

> The bill, provides a special rule to cover the possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure. Tax Report Act of 1976, P.L. 94-455 pg. 186.

This massive overhaul of the gift tax

provisions with a specific address to the income taxation of highly appreciated property transferred to a trust - the identical type transfer made by the Cleavers - was not enacted in a vacuum. The IRS had advanced its theories to create income tax consequences in gift transfers through the courts for fourteen years.

The specific part sale part gift theory advanced here had been rejected by the Tax Court, and the Fourth, Fifth and Sixth Circuits for eight (8) years prior to Congress' enactment of the Tax Reform Act of 1976. If Congress sought to legislate a result contrary to this impressive precedent, it would have done so as part of the Tax Reform Act of 1976.

As a general rule, this Court has consistently recognized that Congress is presumed to have knowledge of applicable judicial precedent when enacting legislation. In Callanan v. United States, 364 U.S. 587, 594 (1961), this Court noted that "Congress is, after all, not a body of laymen with the commonplace of our law. This legislation was the formulation

of the two Judiciary Committees, all of whom are lawyers, and the Congress is predominantly a lawyers' body."

This Court has consistently held that legislation must be construed in terms of judicial precedent in existence at the time of its enactment. In Shapiro v. United States, 335 U.S. 1, 16 (1948), quoting Hecht v. Malley, 265 U.S. 144, 153 (1924) this Court held that:

> "Moreover, there is a presumption that Congress, in re-enacting the immunity provision of the 1893 Act, was aware of the settled judicial construction of the statutory immunity. In adopting the language used in the earlier act, Congress 'must be considered to have adopted also the construction given by this Court to such language, and made it a part of the enactment.'"

Further, in Exploration Company v. United States, 247 U.S. 435, 449 (1918), this Court held that existing caselaw must be looked to in construing acts of Congress:

> "When Congress passed the act in question the rule of Bailey v. Glover [88 U.S. (21 Wall.) 342 (1874)] was the established doctrine of this court. It was presumably enacted with the ruling of that case in mind. We cannot believe that Congress intended to give immunity to those who for the period

> named in the statute might be able to conceal their fraudulent action from the knowledge of the agents of the Government."

Accord, Canada Packers, Ltd. v. Atchison, Topeka & Santa Fe Ry. Co., 385 U.S. 182 (1966). See also, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975); Allen v. Grand Central Aircraft Co., 347 U.S. 535,544-45 (1954).

Likewise, the Federal Courts of Appeal have held that Congress' enactment of legislation must be construed in light of the then existing caselaw. See generally, Toilet Goods Association v. Finch, 419 F.2d 21 (2d Cir. 1969); Kansas City, Missouri v. Federal Pacific Electric Co.. 310 F.2d 271 (8th Cir.), cert., denied, 371 U.S. 912 (1962); Texaco, Inc. v. Federal Power Commission, 317 F.2d 796 (10th Cir. 1963), rev'd on other grounds, 377 U.S. 33 (1964); Jones v. Goodson, 121 F.2d 176 (10th Cir. 1941); Bovay v. H. M. Byllesby & Co., 88 F.2d 990 (5th Cir. 1937); Knowles v. Gladden, 254 F. Supp. 643 (D. Ore. 1965). The Eighth Circuit held:

> "In searching for the will and intent, it is to be assumed that Congress was

> aware of established rules of law applicable to the subject matter of the statute and thus, upon enactment, the statute is to be read in conjunction with the entire existing body of law." Kansas City, Missouri, supra at 272.

There is clearly a "presumption that Congress was aware of the applicable decisions, and its recognition of them, when it enacted [the act in question]." Texaco, supra at 801.

In the recent decision of Illinois Brick Co. v. Illinois, 431 U.S. 720, 733 n.14 (1977), this Court held that Congress' enactment of the Hart-Scott-Rodins Antitrust Improvements Act of 1976, which permitted the individual states to initiate parens patrial suits on behalf of their citizens, must be read in light of existing caselaw which severely limited the standing of potential plaintiffs. In that instance, the Supreme Court had not previously addressed this specific question of antitrust standing and the Court held that Congress enacted the parens patrial legislation with full knowledge that the federal courts of appeal construed such standing very narrowly.

For eight (8) years prior to the

enactment of the Tax Reform Act of 1976, the existing caselaw consistently rejected the IRS part sale, part gift theory. This is not an instance where only a single isolated court decision is involved. See, e.g., United States v Raynor, Indiana, 302 U.S. 540, 551-52 (1941). Given unanimous judicial precedent of this length, Congress by implication codified this existing caselaw. See, e.g., United States v. Chicago, N.S. & M.R. Co., 288 U.S. 1 (1933) (10 years); United States v. Shreveport Grain & Elevator Co., 287 U.S. 77 (1932) (18 years); Duke Power Co. v. South Carolina Tax Commission, 81 F.2d 513 (4th Cir. 1936) (5 years).

### E. TAXPAYERS WERE JUSTIFIED IN RELYING ON THE LONGSTANDING LEGAL PRECEDENT AND THE INTENT OF THE INTERNAL REVENUE CODE REGARDING THE INCOME TAX CONSEQUENCES OF A NET GIFT.

Prior to the Tax Reform Act of 1976, which revamped the gift and estate tax provisions, a common estate planning tool was to gift property in an effort to try to balance the respective graduated tax rates for gifts

and estates. The Congressional action taken in 1976 which adopted a unified tax schedule for gifts and estates spurred many taxpayers, such as the Cleavers, to make substantial gifts prior to the effective date of these changes.

Accordingly, the Cleavers, as many taxpayers, sought counsel for tax planning, and gift programs were designed for their circumstances based on the then existing Internal Revenue Code, treasury regulations, revenue rulings and caselaw. Substantial gifts were made in reliance on the atmosphere of law then existing regarding the tax consequences of net gifts.

The taxpayer contemplating a gift would first look to the IRC and the related treasury regulations to determine the tax consequences of his gift. With respect to transfers of property Congress has enacted separate taxes and provisions in the IRC depending on the nature of the transfer. Therefore, since the transfer contemplated was to be a gift, the applicable tax consequences would be found under the gift tax provisions and applicable

treasury regulations which do not provide for an income tax consequence to the donor regardless of whether or not the donee assumes the gift tax liability. This argument was fully discussed in Part B of the Argument.

After reviewing the applicable IRC provisions and treasury regulations, the cautious taxpayer would examine the pertinent revenue rulings issued by the Service. In the net gift area, the Service had issued several revenue rulings approving the net gift concept. Rev. Rul. 71-232, 1971-1 C.B. 275 as superceded by Rev. Rul. 75-72, 1975-1 C.B. 310, Rev. Rul. 76-57, 1976-1 C.B. 297 and Rev. Rul. 76-104, 1976-1 C.B. 301. For gift tax purposes a net gift is defined as a gift conditioned on the payment of the gift tax by the donee. The net gift value is determined by reducing the gross value of the gift by the amount of the gift tax to be paid by the donee. The above-mentioned revenue rulings contain an elaborate formula to be used for the purpose of arriving at the true tax to be deducted from the value of the gifted property. A reasonable taxpayer

could conclude that this analysis of the tax consequences is the end of the IRS' imposition of tax on his gift transfer. This conclusion would be reinforced by the following sentence found at the end of the above-mentioned revenue rulings: "While the entire transaction is viewed as a gift in part and a sale in part, this Revenue Ruling is concerned only with the gift tax and not with the income tax consequences of the sale." Keeping in mind the caselaw (discussed in Part A of the Argument) existing at the time these revenue rulings were issued, the only logical interpretation of this sentence is that the income tax consequences of the net gift are those which relate to the donee upon his subsequent disposition of the property and the calculation of the donee's basis for purposes of determining gain on such disposition. A taxpayer could certainly conclude if the Service intended the income tax consequences of a net gift to include a taxable gain to the donor,

the Service would simply have stated such.

As the final step in his tax planning, a taxpayer before making a net gift would have reviewed the then existing caselaw. As discussed more fully in Part A of the Argument, by 1976 the Commissioner had presented his position regarding an income tax to a donor of a net gift to the Tax Court, and the Fourth, Fifth and Sixth Circuit Courts and each time his position was rejected. In fact it was not until Diedrich in 1981, many years after the gifts in question were made, that the Commissioner's position was upheld. After a careful review of the state of the law prior to the Eighth Circuit's decision in Diedrich, a taxpayer could only conclude that structuring a gift transaction identical to those found in the caselaw would result in the same tax consequences.

The Eighth Circuit has stated that reliance by Appellants-taxpayers on caselaw precedent is irrelevant since the Eighth Circuit had not decided the issue. While it is true that this is the first opportunity the Eighth

Circuit had to address this issue, it would be ludicrous to suggest that until a given Circuit Court resolves an issue the citizens in that circuit can look to no other jurisdiction, IRC provision, treasury regulations or revenue ruling for guidance in resolving that issue. Were the taxpayers in this appeal and the Cleavers to analyze the law in other jurisdictions, the IRC provisions, the treasury regulations and the revenue rulings to determine the tax consequences of the donee assuming the gift tax liability, they could reach but one conclusion - a net gift results in no income tax consequences to the donor. To ignore this common sense reliance on the state of the law would make effective and intelligent tax planning impossible for taxpayers. The Service and Congress had ample opportunity since 1968, when Turner, supra was decided, to codify the Commissioner's position in this area, but failed to do so. For this Court to act now thirteen years after Turner, supra, would be unfair and inequitable to those taxpayers who made net gifts in reliance on the

state of the law at the time.

III. CONCLUSION.

The facts of the two cases on appeal and of the amicus curaie present a very simple transaction. In each instance the taxpayer-donor gave highly appreciated unencumbered property to a related donee with the only condition being that the donee pay the gift tax liability imposed on the transfer. It is the position of the amicus curaie that there is no question that the transfers were intended by the parties as gifts, and therefore the IRC provisions applicable to gift transfers should be applied.

The Commissioner's position is to take this gift transaction and in addition to the gift tax already imposed, levy a tax based on the premise that the donor receives an economic benefit equal to the gift tax liability paid by the donee since this payment is a discharge of the donor's debt. A discharge of a taxpayer's indebtedness is defined as an item

of gross income under sec. 61(a)(12) IRC; therefore, according to the Commissioner the donor has gross income equal to the gift tax paid by the donee. This reasoning is fallacious since the gift tax liability if not paid can become an economic burden to the donee. Consequently the payment of the gift tax also results in an economic benefit to the donee.

The factual pattern of the gift transactions before the Court is identical to that presented in Turner, supra and clearly distinguishable from Johnson, supra, which was followed by the Eighth Circuit. Both Turner, supra and Johnson, supra are good law and should be applied respectively to similar fact situations. The only decision which should be overruled by this Court is Diedrich which ignores the factual distinctions between Turner, supra and Johnson, supra.

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No. 80-2204

# In the Supreme Court of the United States

**October Term, 1981**

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent,*

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED,
*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## AMICUS CURIAE BRIEF

**On Behalf of Ralph Owen and Lulu H. Owen; John T. Benson, Jr. and Jimmie L. Benson; J. C. Bradford, Sr. and Eleanor Bradford; Joe C. Davis; and Estate of Frances Hampton Currey**

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## AMICUS CURIAE BRIEF

**On Behalf of Ralph Owen and Lulu H. Owen; John T. Benson, Jr. and Jimmie L. Benson; J. C. Bradford, Sr. and Eleanor Bradford; Joe C. Davis; and Estate of Frances Hampton Currey**

MAY IT PLEASE THE COURT:

This *amicus curiae* brief is filed in support of the position of Petitioners in this case on behalf of the following

appellees in cases pending in the Sixth Circuit Court of Appeals:

Ralph Owen and Lulu H. Owen

John T. Benson, Jr. and Jimmie L. Benson

J. C. Bradford, Sr. and Eleanor Bradford

Joe C. Davis

Estate of Frances Hampton Currey

## INTEREST OF THE AMICI CURIAE

The interest of the *amici curiae* can best be seen from the following historical survey.

The first reference to net gifts we find in court decisions was in *Sarah Helen Harrison v. Commissioner*, 17 T.C. 1350 (1952), involving the amount of the gift tax. The Commissioner of Internal Revenue contended that the gift tax should be applied to the gross gift. In ruling for the taxpayer the Tax Court said (p. 1357):

> Respondent asserts that gift tax "is measured by the value of the property passing from the donor." Regulations 108, section 86.3. This is true if the property passes from the donor with all the elements of a gift. Cf. *Commissioner v. Hogle*, 165 F.2d 352, 353, affirming 7 T.C. 986. One of the essential elements of a gift is the donor's intention to make the gift. Petitioner did not intend that the amount of the value of the property necessary for the gift tax liability would be a gift to the trust. Therefore, in the absence of an intent to give, this amount was not effective as property passing from the donor, and not taxable as a gift.

As used in the brief and in the cited cases, a net gift is a gift on condition that the donee pay the gift taxes or that the donee agree to pay the gift taxes.[1]

In Rev. Rul. 57-564, 1957-2 Cum. Bull. 328, the Commissioner responded to a request ". . . with respect to the Federal income tax consequences to a donor, pursuant to a trust instrument, requiring the donee trust to pay the Federal gift tax on the gift of such stock. . . ." The Commissioner ruled that ". . . income of the trust which is applied by the trustee in satisfying the obligation incurred to pay gift tax of the donor, is taxable to the donor under the provisions of Section 677 of the Code." There was no suggestion of any other "income tax consequences" and the implication of this omission was that there were none. Certainly there was no administrative construction of any Federal tax law that there were such consequences prior to the cases now to be referred to.

The first decided case in which the I.R.S. made the contention that a capital gain was realized by a donor who made a net gift where the gift tax exceeded the donor's basis in the donated property was *Turner v. Commissioner*, 49 T.C. 356 (1968).[2] The Tax Court rejected the conten-

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1. Assuming a gross gift of $1,000, and a Federal gift tax rate of 25%, the formula to arrive at the amount of the net gift would be: $X + 25/100\ X = 1{,}000$; $125\ X; = 100{,}000$; $X = 800$. The computation becomes more complicated when different gift tax brackets are involved and when the gift is considered as made one-half by the donor and one-half by his spouse. See Rev. Rul. 75-72, 1957-1, Cum. Bull. 310. In this brief, for the sake of simplicity, state gift taxes will be ignored.

2. The Commissioner argued for a capital gain tax only in the case of a gift to an individual, conceding that there was none in the case of a gift to a trust. The reason for the concession is unclear, but was possibly on the theory that the only income tax consequences of a net gift to a trust were those based on Sections 671 and 677 of the Code. In later cases the Commissioner made the same argument whether the gift was to a trust or to an individual.

tion; the Commissioner appealed to the Sixth Circuit Court of Appeals, and that Court affirmed the Tax Court, 410 F.2d 752 (6th Cir. 1969). The same contention was then made and rejected by the Tax Court in *Estate of Davis v. Commissioner,* T.C. Memo 1971-318 (30 T.C.M. 1363); the Commissioner appealed to the Fifth Circuit Court of Appeals, and that Court affirmed the Tax Court, 469 F.2d 694 (5th Cir. 1972). Then again in *Krause v. Commissioner,* 56 T.C. 1242 (1971), the Commissioner advanced the same contention as an alternative to his contention that the use of proceeds of sale of donated property for payment of the gift taxes resulted in income to the donor. The Tax Court, in an opinion reviewed by the Court, held with one judge dissenting, that the taxpayers realized income under Sections 671 and 677 of the Code in the amount of the income received by the trusts *prior* to the payment of the gift tax liabilities, but unanimously held that they did not realize any other income as a result of the payment of such taxes. Both parties appealed to the Sixth Circuit Court of Appeals, but both parties then dismissed their appeals on June 27, 1972.

There was no other case pending in any other circuit in which the Commissioner was making the contention now made, except *Hirst v. Commissioner,* 63 T.C. 307 (1974). In view of the state of the law, it is likely that the Commissioner would not have pursued the *Hirst* case had it not been for a decision of the Sixth Circuit Court of Appeals in *Johnson v. Commissioner,* 495 F.2d 1079, decided April 9, 1974. This is the case on which the Eighth Circuit Court of Appeals mainly relied in the instant cases. The facts in *Johnson* were that the taxpayers, who owned corporate stock of high value but a low tax basis, borrowed money on non-recourse notes from a bank and then made gifts of the stock to trusts, subject to the encumbrances of

the bank loans. The donors paid the gift taxes on the gross gifts, using part of the proceeds of the bank loans to do so, but were free to use these proceeds any way they chose.

Prior to the *Johnson* transactions, there had been at least two decisions with facts almost identical in which the Commissioner had prevailed. These were *Simon v. Commissioner*, 285 F.2d 422 (3rd Cir. 1960), affirming 32 T.C. 935, and *Magnolia Development Company v. Commissioner*, T.C. Memo 1960-177 (19 T.C.M. 934). The factual differences were that in *Simon* the gift was to a controlled corporation and in *Magnolia Development Co.* the gift was to a charity, so that in neither case were gift taxes involved. In each case it was held that the fact that the donor had borrowed the money and then transferred the property was a matter of form rather than substance and that the donee in each case was really buying the property for the amount of the loan. These cases were presumably known to the Johnson brothers or their tax counsel when they engaged in the transactions in controversy, but by the time deficiency notices were issued, *Turner* had been decided, and they decided to contest the deficiencies on the ground that they also had "in substance" made net gifts. The Tax Court disagreed, and they appealed to the Sixth Circuit Court of Appeals, where they found a sympathetic ear. The panel of that Court which heard the case, in an opinion by Judge Celebrezze, affirmed the Tax Court, but in doing so took occasion, in *dicta*, to disapprove *Turner*. Reliance for this view was placed on *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) and *Crane v. Commissioner*, 331 U.S. 1 (1947). Neither of these cases had been relied upon in *Simon* or in *Magnolia Development Co.*, although Judge Bruce, for the Tax Court in *Johnson v. Commissioner*, 59 T.C. 791 (1973), had partially relied upon *Crane*, saying that its "rationale" had been applied "in

situations analogous in many respects to the present case." (p. 810). As to *Turner*, Judge Bruce said that it was "distinguishable both on the facts and the issues presented." (p. 812). There was no one to urge the correctness of *Turner* before the *Johnson* Court. The Commissioner argued that its was incorrectly decided, and the taxpayers' main thrust was that they should have the benefit of the decision although they had not made net gifts.

It was in 1972 and 1973, *after* the dismissal of the appeals in *Krause*, and prior to the decision in *Johnson*, that the gifts of the taxpayers, who are the *amici curiae* in these cases, were made. Solely as a result of the *dicta* in *Johnson*, the Internal Revenue Service reactivated its position that such gifts generated taxable income. Statutory notices were duly issued, and petitions duly filed with the Tax Court for redetermination of the deficiencies. The opinions in the Tax Court, all in favor of the taxpayers on this issue, were as follows:

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|---|---|
| Ralph Owen, et ux. | No. 8960-75, T.C. Memo 1978-51 filed Feb. 6, 1978 |
| John T. Benson, Jr., et ux. | No. 5885-76, T.C. Memo 1978-231 filed June 21, 1978 |
| J. C. Bradford, et ux. | No. 5701-76, 70 T.C. 584 (1978) filed July 31, 1978 |
| Joe C. Davis | No. 5831-76, 74 T.C. 881 (1980) filed July 31, 1980 |
| Estate of Frances F. Currey | No. 2219-78, T.C. Memo 1981-40 Feb. 2, 1981 |

The Tax Court did not hear the *Hirst* case until after the decision of the Sixth Circuit Court of Appeals in *Johnson*. It then reaffirmed its prior decisions in spite of the *dicta* in *Johnson* upon which the Commissioner had

relied. The Commissioner appealed to the Fourth Circuit Court of Appeals, which, after an *en banc* hearing, by a vote of five to three, affirmed the Tax Court in an opinion by Chief Judge Haynesworth, *Hirst v. Commissioner,* 572 F.2d 427 (4th Cir. 1978). Subsequently, the Tax Court decided the cases pending before it and the Commissioner promptly appealed all of them. Oral argument was heard in the Sixth Circuit in only one of these cases, *Owen v. Commissioner,* No. 78-1341. This case was decided by the Tax Court February 6, 1978, T.C. Memo 1978-51, and was orally argued on appeal June 6, 1980, and finally decided June 23, 1981 on the basis of *stare decisis. Owen v. Commissioner,* 652 F.2d 1271 (6th Cir. 1981). Meanwhile, in the Eighth Circuit, the two cases now before the Court, decided by the Tax Court on November 8, 1979, T.C. Memo 1979-441, and February 27, 1980, T.C. Memo 1980-50, respectively, were argued on January 15, 1981, with a decision in favor of the Commissioner on March 4, 1981, *Diedrich v. Commissioner,* 643 F.2d 499 (8th Cir. 1981). In all the Sixth Circuit cases the Commissioner's argument both in the Tax Court and in the Court of Appeals has been that the cases were "controlled by *Johnson,*" and in the Eighth Circuit *Johnson* was strongly relied upon.

In addition to the cases of the *amici curiae,* there is also pending in the Sixth Circuit the Commissioner's appeal from the Tax Court's decision in *Estate of Henry v. Commissioner,* 69 T.C. 665, filed February 6, 1978. All of these cases are being held in abeyance pending the decision of this Court in the present cases. In the *Owen* case the court has granted the Commissioner's Petition to Rehear En Banc and the case has been restored to the docket as a pending appeal.

## SUMMARY OF ARGUMENT

Where a donor makes a gift of appreciated property to a donee in a lower tax bracket, e.g., a trust which distributes all its income except capital gains, and the donee sells the property, or a part of it, his capital gain tax is naturally less than the donor's tax would have been if the donor had sold the same property. Hence, when a donor makes a gift of appreciated property on condition that the donee pay the gift taxes, or that he agree to pay them, and the donee sells some of the property to raise the necessary funds, the Internal Revenue Service collects a smaller amount of capital gain taxes than if the donor had sold the same property to pay the same gift taxes. This is the tax advantage of making so-called net gifts.

The Commissioner of Internal Revenue contends in these cases and in the cases involving the *amici curiae* that where the gift taxes exceed the basis of the donated property, the excess is a capital gain to the donor, relying largely upon *Old Colony Trust Company* and *Crane*, which were also relied upon by the Sixth Circuit Court of Appeals in the *Johnson dicta* disapproving *Turner*. Neither of these cases support the Commissioner's contention. *Old Colony* involved the indirect payment of additional compensation to an employee in the form of the payment of his income taxes and the decision is applicable only in such an income-generating context. It is not applicable in non-commercial transactions between family members. *Crane* involved a taxable "disposition" of property and determined the "amount realized" under the provision of the 1939 Code which corresponded with Section 1001(a) of the 1954 Code. In the cases at bar, the "disposition" of the property was not a taxable disposition, and *Crane* is inapplicable. Moreover, *Crane* involved a sale of de-

preciable real estate on which the taxpayer had taken sizable depreciation deductions over a period of years, and this was said by the Court to be the "crux" of the case. The Court was careful to point out what it was not deciding. The Eighth Circuit Court of Appeals was incorrect, in the cases at bar, in treating the *Johnson* type of transaction the same as a pure net gift.

This Court should give great weight to the numerous decisions of the Tax Court holding that net gifts do not generate taxable income and to the fact that when these gifts were made, all prior to the *Johnson* decision, the law was well settled in favor of the taxpayers, both in the Tax Court and in the Sixth Circuit where the *amici curiae* all resided. Moreover, the concept of taxable income envisioned by the *Johnson* Court and the Eighth Circuit Court of Appeals in these cases is contrary to the concept of income under the Sixteenth Amendment.

At any rate, the remedy, if one was needed, was for Congress to apply, and Congress, in the Tax Reform Act of 1976, enacted such reforms as it considered necessary, including the incorporation of Section 644 into the Internal Revenue Code, imposing on donee trusts which sell property within two years of the transfer of the property a special (but non-retroactive) tax equivalent to any tax bracket savings otherwise realized by the donee trust as compared with the tax which would be imposed on the donor if the donor had sold the same property. The Commissioner in these cases seeks to have a special tax imposed by judicial fiat, not on the donee, but on the donor, creating in the case of net gifts to trusts an incongruous situation.

Finally, should the Court agree with the Commissioner and affirm the reversals of the Tax Court by the Eighth Circuit Court of Appeals, the reversals of the Tax Court should be non-retroactive.

## ARGUMENT

### Structure of a Net Gift

The simplest form of a net gift is a gift of money. Assuming a gift tax rate of 25%, the donor who makes a net gift of $800 will make a gross gift of $1,000, and the additional $200 does not "vanish into thin air", to use the language of Judge Raum in *Hirst* (63 T.C. at p. 315); it goes into the United States Treasury. Obviously, the tax consequences are exactly the same whether the donor makes a gift of $800 and pays the gift tax of $200, or makes a gift of $1,000 conditioned on payment of the gift tax by the donee.

The next simplest form would be a gift of property, plus enough money to pay the gift tax; eg. shares of stock worth $800, plus $200 in money. Here, as pointed out by Judge Featherston in *Krause*, the transfer of money in the amount of the gift tax, and the use of the money for payment of the gift tax, would not generate taxable income. The donee simply pays the money into the Treasury as before. Again, the tax consequences are exactly the same as if the donor had made a gift of the property only, and paid the gift tax himself.

The usual form of net gift, however, would be (using the same figures) a gross gift of shares of stock of a value of $1,000, in which case the donee could sell $200 worth and pay the gift tax. This was the form of net gift involved in *Owen*, where the exact language of each of the trust agreements was as follows:

(d) This gift is on the express condition that the Trustee report and pay out of the trust estate all gift taxes, both state and federal, which may be imposed upon donor by virtue of this gift. The Trustee is authorized to borrow the money with which to pay said taxes, or any part thereof, and to repay said loan or loans by selling, from time to time, property comprising a part of the trust estate. The interest on said loan or loans may be paid out of the income of the trust or by selling property in the trust estate, in the sole discretion of the Trustee.

To avoid any impact of Sections 671 and 677 of the Code, the trusts borrow the money for the gift taxes and after payment sell enough of the property to repay the loans. The *only* tax disadvantage to the Treasury is that it receives less capital gain taxes than if the donor, in a higher tax bracket, had made the sale to raise the necessary funds for the gift taxes.

A variation of this form of net gift would be one in which the donee pays the gift tax with his own funds, which would probably be the residue of taxable income after payment of income taxes. Such was the form of net gift described in *Sarah Helen Harrison*, and also the form of net gift in *Hirst*, where real estate was donated.

In *Diedrich*, the Court said in Footnote 7, that the characterization of a transaction for gift tax purposes is irrelevant in a case involving income taxes. Obviously the income tax consequences of a transaction are different from the gift tax consequences, but the transaction itself is the same. If the transaction is a non-commercial transaction for gift tax purposes, it is also a non-commercial transaction for income tax purposes, and if the donee is merely the conduit for the payment of the gift taxes in the gift

tax context, he remains merely a conduit in the income tax context.

Another variation in the form of net gifts is that the gift may be conditioned either on the payment of the gift tax by the donee, or on the agreement of the donee to pay the tax. Here we run into the distinction between a condition and a covenant, and if the gift is conditional, the distinction between a condition precedent and a condition subsequent. It is submitted that the gift in *Owen* was on a condition precedent. In other words, the gift was not a completed gift until the payment of the gift tax. See *Cannon v. Apperson*, 14 LEA (82 Tenn.) p. 553, opinion by Judge William F. Cooper, one of Tennessee's most distinguished jurists, holding that when a condition upon which a legacy depends is precedent, the legatee has no vested interest until the condition is performed.

**The Commissioner's Theory of Tax Liability**

Prior to the decision of the Sixth Circuit Court of Appeals in *Johnson*, the Commissioner consistently contended in the net gift tax cases that the taxpayer made a sale of the donated property for the amount of the gift tax, and a gift to the extent that the market value of the donated property exceeded the amount of the gift tax. One difficulty with this approach, as indicated in the opinion of Judge Raum in *Hirst* (63 T.C. at p. 315), was that if the basis of the donated property exceeded the amount of the gift tax, the taxpayer would have a recognizable loss. This was also pointed out in *Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980).

*Johnson* was in all significant respects similar to *Simon v. Commissioner, supra*, and *Magnolia Development Company, supra*, where the courts regarded the transactions as part gifts, part sales. When *Johnson* reached the Sixth

Circuit Court of Appeals, however, that Court rejected the part gift, part sale theory, and advanced a new theory, which was apparently thought to satisfy both the *Johnson* type of transaction and the net gift type of transaction; viz. the theory of economic benefit, bottomed largely on *Old Colony Trust Company*, where a corporate officer was held to have derived additional compensation from the payment of his income taxes by his employer. The Court theorized that the donor is "primarily liable" for the gift tax, and that if the donee pays the gift tax, this constitutes income to the donor.

On this theory, however, the income would be the amount of the gift tax without regard to the basis of the donated property, and it would be ordinary income and not capital gain. Nevertheless, the Commissioner contends in such a case that the donor realizes taxable income to the extent only that the amount of the gift tax exceeds the adjusted basis in the donated property and that it is a capital gain rather than ordinary income.

There are several other troubles with this theory. In the first place, the payment of another's tax liability does not necessarily generate income. As pointed out by Judge Haynesworth in *Hirst* (572 F.2d at p. 431) payment of a tax for someone else may be a gift, depending on the circumstances. For example, a parent may pay a daughter's note at a bank as a gift to the daughter. The net gift tax transaction could be characterized as reciprocal gifts, which are netted out for gift tax purposes.

In the second place, it is incorrect to say that the donee is paying the donor's obligation. It is true that the donor is liable for the gift tax if the donee fails to pay, but as between donor and donee, the obligation to pay is that of the donee, if there is any obligation at all. An accommoda-

tion maker of a note to a bank is primarily liable to the bank, but the obligation is really that of the accommodated party and if the latter pays the note, it would be incorrect to say that he is paying the obligation of the accommodation maker. Moreover, in the case of the gift on the condition precedent that the donee pay the gift tax, the gift is not complete until the gift tax is paid and it would therefore be incorrect to say that either the donor or the donee has a prior obligation to pay the tax. The obligation, the payment, and the completion of the gift are all simultaneous.

In the third place, the economic benefit to the donor in a net gift transaction is simply that the donor has made a smaller gift rather than a larger one. He is obviously worse off economically than if he had made no gift, but it would be farfetched to say that although one is better off making a gift of $100 rather than a gift of $200, he realizes taxable income and incurs an income tax in so doing.

Finally, adopting the rationale of *Sarah Helen Harrison* and *Krause,* the donee in a net gift transaction is merely a conduit. The donor furnishes either the funds for payment of the gift taxes or the equivalent in property, which the donee is free to sell to raise the funds.

**The Tax Reform Act of 1976**

In the Tax Reform Act of 1976, Public Law 94-455, one of the concerns of Congress was "the possible tax abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of any capital gains tax to the trust at its lower progressive rate structure." Ways and Means Committee Report [H. Rpt. No. 94-658, 94th Cong. 1st Sess. (November 12, 1975)] p. 183. The final result was Section 701(e) of the Act, incor-

porating a new Section 644 into the Code, whereby "the trust is taxed at the grantor's rate brackets on 'built in' gain occurring within 2 years of transfer to the trust." Conference Report [H. Rpt. No. 94-1515, 94th Cong. 2d Sess. (September 13, 1976)] p. 441.

It is significant that the Commissioner does not contend in the cases under consideration, and has not contended in any of the net gift cases, that the donor is the real taxpayer where the donee sells a part of the donated property to raise the funds for payment of the gift taxes. There is no contention that the capital gain taxes incurred by the donee should be measured by the donor's tax bracket rather than the donee's. If such contention were made, one conclusive answer would be, at least where the donee is a trust, that Section 644 of the Code applies only to transfers to trusts after May 21, 1976. As previously shown, the difference in tax brackets of donor and donee is the source of the Commissioner's dissatisfaction with net gifts and the correlative advantage to taxpayers. This is not to say that in some cases there may not be a practical reason for a net gift, as where the donor does not have the funds to pay the gift taxes and does not want to sell any part of the property, whereas the donee does have the funds; e.g. in *Hirst*, where an 80 year old widow with limited liquid assets gave undeveloped land to her grown son and his family on condition that he pay the gift taxes. But the Commissioner has no just cause for dissatisfaction in such a case because the funds used by the donee are probably the residue of taxable income on which he has previously paid (or will pay) the required income tax, at perhaps a relatively high rate.

Congress was evidently concerned in the Tax Reform Act of 1976 with reforms in this whole area of taxation. Not only did it add Section 644 to the Code, but also by

Section 2005(c) of the Act added to Section 1015(d) of the Code a new paragraph 6, providing a special rule for gifts made after December 31, 1976, as to increased basis for gift tax paid. Instead of increasing the donee's basis by the full amount of the gift tax paid there is added only a proportionate amount bearing the same ratio to the amount of tax paid as the net appreciation in value of the gift bears to the amount of the gift.[3] This has the effect, of course, of lowering the donee's basis and increasing the amount of his capital gain tax when he sells. But Congress did not incorporate into this complex body of tax law the incongruous concept advocated by the Commissioner in these cases.

**The Crane Case**

In *Johnson* the Sixth Circuit Court of Appeals relied not only on *Old Colony Trust Company*, but on *Crane*. *Crane* was cited for the proposition that a non-recourse encumbrance must be included in the "amount realized on the sale or other disposition of property under Section 1001 (a) of the Code." This Court did make that holding as applied to the facts of the particular case where there was

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3. The reason for the change was given as follows by the House Ways and Means Committee:

> 4. The basis of property acquired by gift generally is the basis of the property in the hands of the donor plus any gift taxes paid on the gift. The purpose of the increase in basis for gift taxes paid on the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, existing law is too generous in that it permits the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the bill provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift. H. Rpt. No. 94-1380, 94th Cong., 2d Sess., August 2, 1976 pg. 44 of Rpt.

a sale of property which the taxpayer had inherited subject to a mortgage indebtedness. She had taken sizable depreciation deductions prior to the sale, and then made a sale subject to the mortgage indebtedness which had increased because of accrued and unpaid interest. It does not follow, however, that every "disposition" of property subject to an encumbrance is a taxable event. As pointed out in *Evangelista*, Section 1001(a) simply provides for the computation of the gain after it has been determined under some other section of the Code that the disposition in question was a taxable disposition.[4]

The Court in *Crane* said that the "crux" of the case was "whether the law permits her [the taxpayer] to exclude allowable [depreciation] deductions from consideration in computing gain." (331 U.S. at p. 15). The depreciation deductions actually taken, according to the Tax Court opinion aggregated $28,500, while the allowable depreciation was $28,045.10, which added to the $2,500 cash realization would produce a taxable gain of $30,545.10. On the theory that a non-recourse encumbrance is to be included in the amount realized, the gain should have been the net proceeds of sale plus the total amount of the encumbrance, minus the adjusted basis: $2,500 + $270,857.71 - $233,197.40 = $40,160.31. The amount of the gain actually determined was the net proceeds of sale plus the principal (only) of the encumbrance, minus the adjusted basis: $2,500 + $255,000 - $233,197.40 = $24,302.60. The Court did not concern itself with the minutiae of the computation, but contented itself with accepting the agent's determination.

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4. "This provision [§1001(a)] is purely computational; it leaves to other provisions the task of determining whether the amount so computed is taxable or deductible, recognized or not recognized, and capital or ordinary." Boris J. Bittker, Federal Taxation of Income, Estates and Trusts (1981) ¶43.1.

The Court, in *Crane*, evidently realizing the potential confusion likely to be engendered by the decision, was careful to point out in Footnote 37 of the opinion what it was *not* deciding. Nevertheless, some subordinate courts, as well as commentators, have attempted to stretch the decision beyond the limits imposed by the Court.[5] Certainly the *Crane* decision is completely inapposite in a case involving a gift of non-depreciable property. Whether or not such cases as *Johnson* were correctly decided is not here at issue; however, if they were correctly decided, it would not be on the authority of *Crane*, but on the principle that one who borrows money on appreciated property, and then makes a gift of it subject to the debt which is in excess of the basis of the property, has realized income to the extent of this excess. It is unnecessary to rely on *Crane* to reach this decision.

The Commissioner is inconsistent in relying upon *Crane* upon the merits and then asserting that the alleged income is realized in the year that the donee pays the gift taxes, rather than in the year of the transfer. Although the Commissioner has made a labored attempt to escape this dilemma, it is submitted that he cannot do so and that by contending that the supposed income was realized in the year of payment rather than in the year of transfer, he has in effect abandoned his reliance on *Crane*. It is interesting to note that the Commissioner at one time recognized the complete inapplicability of *Crane* in the present situation. In *Johnson*, the Solicitor General filed a Memorandum in

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5. The first sentence in Footnote 7 in the *Owen* opinion (652 F.2d at p. 1275) is an example. The confusion engendered by *Crane* is illustrated in two recent cases in which the courts reached opposite conclusions: *Millar v. Commissioner*, 577 F.2d 212 (3rd Cir. 1978), cert. denied 439 U.S. 1046 (1978) and *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), where the Court "decline[d] to extend it [the *Crane* decision] beyond the facts of that case."

opposition to the taxpayers' petition for certiorari which had been based, in part, upon an alleged conflict between the Sixth Circuit decision in *Johnson* and the Fifth Circuit decision in *Estate of Davis*. In arguing that there was no conflict, the respondent said:

> Moreover, unlike this case, *Davis* did not involve the transfer of property subject to a pre-existing lien which rendered the amount of the lien an "amount realized" under this Court's *Crane* decision.

*Davis* is, of course, on all fours with the cases at bar; and if *Davis* was unlike *Johnson*, it follows that the cases at bar are also unlike *Johnson*. In fact, as we see *Johnson*, it bears little resemblance to the net gift type of transaction here involved, but closely resembles such cases as *Simon* and *Magnolia Development Company*.

### The Constitutional Concept of Income

A "frequent recurrence to fundamental principles"[6] is equally as essential in jurisprudence as in political and governmental affairs. In Federal income tax cases, Congressional authority stems from the Sixteenth Amendment, and the Internal Revenue Code must be applied so as not to violate the constitutional concept of income.[7] It is a fundamental principle, we submit, that a gift does not

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6. Paragraph 15 of the Virginia Bill of Rights, 1776, reads as follows:

> That no free government, or the blessings of liberty, can be preserved to any people, but by a firm adherence to justice, moderation, temperance, frugality and virtue, and by frequent recurrence to fundamental principles.

7. Cf., footnote 42 of *Crane*, 331 U.S. 1 at p. 15, *supra*, where, in referring to a hypothetical case, the Court said that it would raise a question as to whether "either statutory or constitutional income" would be realized by the hypothetical taxpayer. This demonstrates that constitutional concepts in income taxation are not obsolete.

give rise to income, in the constitutional sense, either to donor or donee. Nor has Congress undertaken to impose such an income tax, thereby forcing the Commissioner in this case to rely upon the general language of Section 61 that "gross income means all income from whatever source derived."

We respectfully submit that the derivation of income from a transaction which leaves taxpayers "in fact poorer by virtue of the entire transaction" (*Commissioner v. Rail Joint Co.*, 61 F.2d 751 (C.A. 2, 1932)) is completely foreign to the constitutional concept of income under either the Sixteenth Amendment or Section 61 of the Code. The Sixteenth Amendment authorizes the taxation of "income" but it does not authorize the taxation of an integrated transaction which merely leaves the taxpayer better off than he might have been, although worse off than before the transaction was entered into. *Cf., Eleanor A. Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956) opinion by Judge Stewart, later Mr. Justice Stewart. There have been many definitions of "income". Among the cases cited in *Bradford* on that subject was *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940), from which we quote as follows:

> 'Income' within the purview of the Revenue Acts, has been defined to be 'gain derived from capital, from labor, or from both combined,' and includes 'profit gained through sale or conversion of capital.' Bowers v. Kerbaugh Empire Co., 271 U.S. 170, 46 S. Ct. 449, 451, 70 L.Ed. 886. 'In determining the definition of the word "income" thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been

in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.' Merchants' L. & T. Co. v. Smietanka, 255 U.S. 509, 519, 41 S. Ct. 386, 389, 65 L.Ed. 751, 15 A.L.R. 1305.

It cannot be plausibly argued that the word "income" had, when the Sixteenth Amendment was adopted, the meaning attributed to it by the Commissioner in the instant cases. A donor has the right to determine for himself the extent of his generosity, and if he wishes only to give the value of stock *less the amount of the gift taxes payable by reason of the gift,* it is difficult to understand how he can be said to have realized income merely because the amount of the gift taxes exceeds the cost of the stock.

On the constitutional concept of income, we refer the Court to *Edwards v. Cuba Railroad,* 268 U.S. 628 (1924), where the Court said: "The Sixteenth Amendment, like other laws authorizing or imposing taxes, is to be taken as written and is not to be extended beyond the meaning clearly indicated by the language used." (p. 631). The Court held that subsidy payments to the railroad company "not made for services rendered or to be rendered" were not "profits or gains from the use of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment." (p. 633).

**The Weight to Be Given the Tax Court Decisions**

At the time the transfers of the *amici curiae* were made, the Commissioner had apparently abandoned, at least in the Sixth Circuit, the contention that a net gift results in the realization of income to the donor in any case except one controlled by Code Sections 671 and 677. Having appealed the decision of the Tax Court in *Krause,* he permitted his appeal to be dismissed on June 27, 1972 for want of prosecution. This left the decision in *Turner* as

the unchallenged authority on the issue in the Sixth Circuit. Moreover, the Fifth Circuit Court of Appeals had affirmed *Estate of Davis.*

The rule of *stare decisis* is peculiarly applicable with respect to judicial decisions affecting the business interests of the country, estate planning, income taxation and the like. The reason was aptly stated in *United States v. Byrum,* 408 U.S. 125 (1972), where the Commissioner, in a case involving Section 2036(a)(2) of the Code, sought to impose an estate tax on trust property on the ground that the settlor retained voting control of corporations whose stock was transferred, and was in position to select the corporate directors who, in turn, passed on dividend policy. Citing *Reinecke v. Northern Trust Company,* 278 U.S. 339 (1929) and *Estate of King v. Commissioner,* 37 T.C. 973 (1962), the Court said (p. 134):

> Essentially the power retained by Byrum is the same managerial power retained by the settlors in *Northern Trust* and in *King.* Although neither case controls this one—*Northern Trust,* because it was not decided under § 2036(a)(2) or a predecessor; and *King,* because it is a lower court opinion—the existence of such precedents carries weight. The holding of *Northern Trust,* that the settlor of a trust may retain broad powers of management without adverse estate-tax consequences, may have been relied upon in the drafting of hundreds of *inter vivos* trusts. The modification of this principle now sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been "controlling" stockholders of a closely held corporation. Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxa-

tion requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

This was not a new application of *stare decisis*. In *National Bank v. Whitney*, 103 U.S. (13 Otto) 99 (1880), the Court was confronted with a contention that real estate mortgages taken by national banks to secure future advances on loans were *ultra vires* and unenforceable. There had been a decision two years previously to the effect that the prohibitory clause of the banking law with respect to loans on real estate did not vitiate real estate securities taken for loans, but "only laid the association open to proceedings by the government." In the case before it, the Court said:

> The construction of the act of Congress thus given has been acted upon by the national banks throughout the country ever since it was published. It is not unreasonable to suppose that they have conducted their business and made loans to a large amount in reliance upon it, and that in many cases great injury would follow a departure from it. Judicial decisions affecting the business interests of the country should not be disturbed except for the most cogent reasons, certainly not because of subsequent doubts as to their soundness. The prosperity of a commercial community depends in a great degree, upon the stability of the rules by which its transactions are governed. If there should be a change, the legislature can make it with infinitely

less derangement of those interests than would follow a new ruling of the court, for statutory regulations would operate only in the future.

The statement most often quoted on *stare decisis* is that of Justice Brandeis in his dissenting opinion in *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932). "*Stare decisis* is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation."

It is recognized, of course, that this Court has not previously spoken on the issue presented, so that *stare decisis* in the usual setting is not applicable. Nevertheless, the principles of Federal tax law relied upon by the taxpayers were firmly embedded in the court with special expertise in tax matters,[8] with the concurrence of two Circuit Courts of Appeal, including that of the Circuit where the *amici curiae* resided. Judge Edwards, of the Sixth Circuit, in his dissenting opinion in *Owen*, apparently recognized the inequity of a retroactive reversal of *Turner*, and we urge upon the Court that should the decision be to affirm the present cases from the Eighth Circuit, reversing the Tax Court, the reversal of the Tax Court should

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8. Mr. Justice Jackson, dissenting, in *Arrowsmith v. Commissioner*, 344 U.S. 6, 12 (1952): "Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of *Dobson v. Commissioner*, 320 U.S. 489 (1943), by the recent revision of the Judicial Code, Act of June 25, 1948, 36, 62 Stat. 991-992, I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own." The Tax Court has expressed its judgment on the net gift issue in not less than twelve cases.

be non-retroactive. The criteria outlined in *Chevron Oil Company v. Huson*, 404 U.S. 97, 105-109 (1971) are clearly met.

This, however, is a case where the remedy, if one is needed, should be with Congress—not with this Court. *Hanover Bank, Executor v. Commissioner*, 369 U.S. 672 (1962). Actually, as previously shown, Congress has already, in the Tax Reform Act of 1976, adopted the reforms it considered necessary, but the one proposed by the Commissioner was not one of them.

In 1974, Judge Raum commented in *Hirst* (63 T.C. at p. 315) that it was "now too late to wipe the slate clean and start all over again." In view of the Tax Reform Act of 1976, it is now impossible to wipe it clean and start all over again. The petitioners in this case, and the *amici curiae*, all followed both the statute law and the judge-made law as it existed at the time they made their gifts, and that is the law which should now be applied.

## CONCLUSION

The decisions of the Eighth Circuit Court of Appeals, reversing the Tax Court, should be reversed, but if affirmed, the reversals of the Tax Court should be non-retroactive.

Respectfully submitted,

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